INTERIM REPORT NO. 4

REGARDING ADDITIONAL

FUNDING FOR OUTSIDE PROFESSIONALS

REVIEWING ALLEGED ILLEGAL ACTS

REPORTEORALD

SAN DIEGO CITY ATTORNEY

MICHAEL Ý ACULĀRÉ

OFFICE OF THE CITY ATTORNEY CITY OF SAN DIEGO

1200 THIRD AVENUE, SUITE 1620 SAN DIEGO, CALIFORNIA 92101-4178 TELEPHONE: (619) 236-6220

9 MAY 2005

EXHIBIT NO. 1

ITEM-S404: Audit Committee of the City of San Diego

(Citywide)

TODAY'S ACTIONS ARE:

Adopt the following resolutions:

Subitem-A: (R-2005-933) ADOPTED AS RESOLUTION R-300203

In order for the City to achieve the full benefit of the work of Kroll Associates, Inc. under an agreement with the City dated February 10, 2005, the City Council affirms to the City's outside Auditor, KPMG, and all interested parties that, for the purposes described in such agreement, Mr. Lynn Turner, Mr. Troy Dahlberg, and Mr. Arthur Levitt are serving as the Audit Committee of the City as contemplated by the Sarbanes-Oxley Act of 2002 (Pub. L. 107-204, 116 Stat. 745).

ADOPTED AND INCORPORATED IN RESOLUTION Subitem-B: (R-2005-933) R-300203 (SUBITEM-A)

In order for the City to expedite the work of the Audit Committee and facilitate the release of the audit letter by the City's independent auditor as well as to demonstrate the continued cooperation by the City of San Diego with the inquiries of the U.S. Securities and Exchange Commission and the U.S. Attorney for the Southern District of California, the City Council approves of the execution of a letter of cooperation.

FILE LOCATION:

Subitems A & B: MEET

COUNCIL ACTION:

(Time duration: 10:38 a.m. - 11:30 a.m.)

MOTION BY PETERS TO ADOPT THE RESOLUTION TO CREATE THE AUDIT COMMITTEE, AND AS PART OF THAT ACTION TO AGREE TO THE EXECUTION OF THE LETTER OF COOPERATION. Second by Madaffer.

Vote taken to appoint the Audit Committee: Passed by the following vote: Peters-yea, Zucchet-yea, Atkins-yea, Young-not present, Maienschein-yea, Frye-yea, Madaffer-yea, Inzunza-yea, Mayor Murphy-yea.

Vote taken to sign the Letter of Cooperation proposed by Mr. Turner: Passed by the following vote: Peters-yea, Zucchet-yea, Atkins-yea, Young-not present, Maienschein-yea, Frye-nay, Madaffer-yea, Inzunza-yea, Mayor Murphy-yea.

NON-DOCKET ITEMS:

None.

ADJOURNMENT:

The meeting was adjourned by Mayor Murphy at 7:13 p.m.

FILE LOCATION:

MINUTES

COUNCIL ACTION:

(Time duration: 7:13 p.m.)

EXHIBIT NO. 2

Kroll

660 South Figuerou, fitr Floor Lus Afigules, 64-60017 tel: 213-442 BÜBÜ Luc 213-442 BÜBÜ

www.krallworldwide.com

May 6, 2005

Mr. P. Lomont Ewell City Manager 202 C Street, Suite 900 San Diego, CA 92101

Re: Audit Committee - Investigation Status

Don Mr. Ewell:

This letter is an effort to update you on the status of the Audit Committee's investigation. Consistent with our engagement letter, the Audit Committee has or is currently performing the following:

- Reviewed the reports and related exhibits prepared by Vinson & Ilkins, the City Attorney, and Luce Forward.
- Meeting and holding discussions with the independent auditors to coordinate its work.
- Ongoing communication with law enforcement agencies.
- Has requested documents and records and is in the process of reviewing information received from the City Attorney, Vinson & Elkins, NTI Breakwater and San Diego Data Processing Center.
- Flas requested the City Attorney provide it with a complete listing of each concern the attorney has with respect to the matters under investigation. Additionally, we have requested documentation supporting the City Attorney's concerns and investigation, including all of the procedures and methodologies applied and all documents identified. We believe it is important issues raised by the City Attorney be thoroughly investigated.

Kroll

Mr. P. Lament Ewell May 6, 2005 Page 2

- Reviewing the work of Vinson & Elkins, including assessing their work product and work papers for their September 16th Report and Phase II of their investigation, in order to determine whether additional procedures need to be performed.
- Meeting with representatives of San Diego City Employees' Retirement System ("SDCERS") and their advisors regarding various issues involved with the investigation.

At this time, Vinson & Elkins's work continues on going with no change in the City's or Audit Committee's relationship. The Audit Committee will use the work completed by Vinson & Elkins, including documents and evidence retrieved, to the extent possible as set forth in our engagement lefter. Of course, as is also set forth in our engagement lefter, we will undertake necessary procedures to cristic an independent thorough and complete investigation.

Questions have been raised as to whether or not Vinson & Elkin's work program wifl result in another report from that firm. The independent auditors have not specifically requested that from the Audit Committee. However, the auditors have requested the Audit Committee provide them with a letter that communicates an independent, complete and thorough investigation has been completed in the opinion of the Audit Committee. They have also asked for our opinion on whether appropriate remediation has been undertaken. Ultimately, we do expect to issue a final report as noted in our contract.

As set furth in the Audit Committee engagement letter signed by the City Mayor, Attorney and Manager and voted on and approved by the City Council, the Audit Committee has determined to retain their own independent legal counsel to obtain guidance on matters of law. The completion of the Audit Committee's work is contingent upon our ability to retain outside independent legal counsel pursuant to the terms of our engagement. This is normal in the scope of investigations that are performed by Audit Committees for public companies. We are faced with a number of major legal issues which require independent legal guidance. These issues include, but are not limited to: investigating certain illegal acts as appropriately requested by the independent auditors and required by generally accepted auditing standards, and SDCERS assertion of privilege. We attach for your information a copy of an article describing how independent investigations are typically conducted. Also attached is guidance by the American Institute of Certified Public

Kroll

Mr. P. Lamont Ewell May 6, 2005 Page 3

Anny makes that is to be followed by independent and items in presenting such a the of the City's financial statements.

Lastly, we have discussed questions regarding the length of time necessary to complete our investigation. We have been clear from the inception of our retention in this matter that we need full cooperation from all parties involved in order to complete our investigation. This will also require full compliance and production requested in subpoena's requested by any law enforcement agency.

The staff of the Securities and Exchange Commission has clearly articulated to the City Mayor, Attorney and Manager and members of the Council that the criteria for cooperation in an investigation, set forth in the accompanying Commission entirecement report commonly referred to as "Seaboard," he met. These criteria apply to all aspects of this investigation. Seaboard requires that entities under investigation, including in this instance the City, all city employees and officials and SDCHR's, fully cooperate and provide complete access to all information as well as thoroughly remediate any issues that are identified during the investigation. To date, complete production of all materials requested by the SEC and the United States Attorney have not occurred in a timely manner. Some documents have not been production was initially set up, but certainly not all of it. But a year into the process, this issue must be quickly addressed, butter managed and production completed.

A copy of a letter from the U.S. Attorney to the Counsel for the Board of Administration of SDCERS, requesting waiver of privilege is attached. Unfortunately, we understand the Board quite inappropriately in our opinion rejected that request. We understand the City Council will rute on a resolution on May 16, 2005, requesting the SDCER's Board waive its privilege and cooperate fully with the law enforcement agencies and Audit Committee. We strongly support passage of such a resolution.

It is also imperative a complete and thorough remediation plan be developed and implemented. Our investigation and recommendations will include addressing the appropriate steps necessary to remediate issues that have, or may arise. Until these issues are resolved, it is difficult if not impossible, to determine when the investigation will be completed. However, we believe that if the criteria of Seaboard

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Mr. P. Lament Bwell May 6, 2005 Page 4

are met soon by all involved, it is important and certainly our goal that the investigation will be resolved before the end of the calendar year.

Sincerely,

Troy Stallbay

Troy Dahlberg

Audit Committee Member

Attachments:

SECURITIES EXCITANGE ACT OF 1934 Release No. 44969 / October 23, 2091

AICPA Practice, Alert 2004-1, Illegal Acts

The Metropolitan Corporate Counsel - Eighteen Safeguards To Corporate Self-Investigation

Letter dated April 14, 2005 from U.S. Attorney Carol C. Lam to Gregory A. Vega, Esquire

EXHIBIT NO. 3



PRIVILEGED AND CONFIDENTIAL ATTORNEY WORK-PRODUCT

February 10, 2005

FROM:

Mayor of San Diego City Council of San Diego 212 C Street San Diego, CA 92101

Re: Independent Services for the City of San Diego

Dear Mr. Ewell:

This letter confirms our understanding of the scope and terms of the engagement of Kroll Inc. ("Kroll") by the San Diego City Council ("the Council"). It is understood that although we are being hired by the Council, we will perform our services with complete although we are being hired by the Council, we will perform our services with complete although we are being hired by the Council, we will perform our services with complete although we are being hired by the Council, we will perform our services with complete although we are being hired by the City's of San Diego ("the City"), the City's including the San Diego Employees' Retirement System ("SDCERS"), the City's elected officials or any other party that is involved with this matter.

Background

On January 27th, 2004, the City of San Diego California made a voluntary disclosure filing with the four Nationally Recognized Municipal Securities Information Repositories recognized by the Securities and Exchange Commission (SEC). The first provided a description of the unfunded accrued actuarial liability of the Sand Diego City Employees' Retirement System together with projections anticipating the growth in the liability, an estimate of the accrued liability for post retirement health care benefits conferred on the City's retired workers, as well as a description of the mechanics by which the City funded the system. The second described numerous errors discovered in the footnotes of the City's audited annual financial statements. Subsequently, rating agencies have downgraded the rating of the City's debt and investigations have been commenced by the SEC and U.S. Attorney.

We understand the City has engaged KPMG to perform an independent audit of its 2003 annual financial statements. We also understand Vinson & Elkins (V&E) issued an investigative report dated September 16, 2004 entitled "The City of San Diego,

EXHIBIT B

California's Disclosures of Obligation to Fund the San Diego City Employees' Retirement System and Related Disclosure practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code." Subsequent to the issuance of this report we understand that KPMG has requested additional competent evidential matter it deems necessary to complete its audit in accordance with applicable accounting, auditing and professional standards and that further investigation be made into certain matters. We also understand V&E has been engaged to perform this additional work. It is our understanding KPMG has requested the results of the V&E investigations, as well as the results of an ongoing investigation by the City Attorney, be received, reviewed and evaluated by an independent third party,

Scope of Project.

The City has requested that Kroll (1) receive, review and evaluate the findings of the investigations by V&E and the City Attorney. The City has also requested Kroll provide. consulting assistance in assessing internal control deficiencies affecting matters discussed in the investigation reports.

The scope of this engagement will be in two phases. The first phase of the engagement will be for Kroll to serve as an Independent Investigator for matters relating to (1) the unfunded liability of the SDCERS and (2) errors discovered in the footnotes of the City's audited annual financial statements. We expect this phase of the project will include:

Working with KPMG to understand their concerns and attempt to reach a satisfactory work program that will assist them in obtaining the necessary. evidence and documentation required by applicable accounting, auditing and

professional standards.

Receive, review and evaluate the reports of investigations of this matter we currently understand will be issued by V&E and the City Attorney. We understand that the Council will direct V&B and the City Attorney to provide us access to whatever information they have related to their investigations. This shall include (a) reading and reviewing these reports, (b) recommending changes in scope of the work performed that will meet the needs of KPMG and where we deem necessary (c) performing additional procedures we consider necessary to reach conclusions or obtain evidential matter that is required by KPMG. In doing so, we will require unconditional access to all information gathered, by the personnel and documents of the City, SDCERS, V&E, the City Attorney and any other parties involved with this matter. We also may direct V&E to perform additional investigative procedures we deem necessary. Should we deem it necessary we may also retain legal counsel. We will attempt not to duplicate work that has already been performed, unless we believe that additional work needs to be done to complete our investigation and provide KPMG with evidence they require in order to issue an opinion on the financial statements. A lack of access to the information or personnel we require may impact our ability to complete our investigation and ability to complete this project.

FAX NO. :

We will report our findings to the Council.

Our work will be based on the investigation reports and any additional procedures we deem necessary. However, we are not responsible for the work performed by V&E or the City Attorney. We are also not responsible for the issuance of audited statements by KPMG or any other external accounting firm the city has hired to audit its' financial statements.

You have also requested a second phase to our engagement, which we will not be prepared to commence until the first phase is complete. In the second phase, we may be engaged to consult with personnel of the City to establish internal controls that if implemented and operated properly by the City could provide reasonable assurance that the transactions identified in the reports in phase one are properly reported and disclosed in the financial statements of the City. We could coordinate our work with the City auditor and Comptroller, the head of the internal audit department and the City's outside independent auditors as to the scope and nature of the internal controls that the City would need to assess, document, implement and test.

The City's internal control over financial reporting includes those policies and procedures that pertain to its ability to initiate, record, process and report financial data consistent with the assertions embodied in either its annual or interim financial statements and accompanying disclosures. Management of the City is responsible for evaluating the effectiveness of the Company's internal control over financial reporting using suitable control criteria and supporting its assessment with sufficient evidence including documentations. Management will also be responsible for presenting a written assessment of the effectiveness of the City's internal controls.

The work performed in connection with phase one and two of this project will be completed in accordance with the applicable professional standards, for consultants, set forth by the American Institute of Certified Public Accountants.

The Council agrees that any written reports, schedules, other materials, or documents prepared or provided by Kroll are to be used only for this matter and will not be disclosed, published, or used by the Council or any representatives of the City for any other purpose without Kroll's prior written permission.

Kroll agrees that all working papers and other documents prepared or received by us pursuant to this engagement will be maintained by us as confidential material and we agree not to disclose our work or work product hereunder to third parties without the Council's consent, except as may be required by law, regulation, or judicial or administrative process, or in connection with litigation arising hereunder. We also agree to abide by any court orders provided to us in writing and signed by us regarding

confidentiality. We will, at your request, transmit information to you by facsimile, e-mail, or over the Internet. If any confidentiality breaches occur because of data transmission, you agree that this will not constitute a breach of any obligation of confidentiality. If you wish to limit such transmission to information that is not highly confidential, or seek more secure means of communication for highly confidential information, you will need to inform us. If access to any of the materials in our possession relating to this engagement is sought by a third party, we will promptly notify you of such action, tender to you our defense responding to such request and cooperate with you concerning our response thereto. In the event that we are subpoenaed as the result of any work performed for you in connection with this engagement, the City will compensate us for our time involved in responding to such subpoenas.

Our fees are based on the actual hours plus expenses incurred and are not contingent on the completion or outcome of the investigation. We will bill you at the rates for the professionals that work on this mater. Our rates currently range from \$125 to \$750 per hour. Our engagement team will be lead by Mr. Lynn Turner and Mr. Troy Dahlberg and under the oversight of Arthur Levitt.

Their respective rates are \$750, \$450 and \$900 per hour, respectively. Our hourly rates are periodically revised. You will pay us for expenses that we incur for this matter, including but not limited to travel costs, lodging, outside research, copy costs, telephone and messengers. We shall be paid for our time and our expenses, including any legal expenses that we may incur, associated with any subsequent testimony or response to any process that is required of us as a result of our services related to this engagement.

We will be pleased to start work upon receiving a \$75,000 retainer that will be applied to the last invoice. We understand that the Council will initially approve \$250,000 for our engagement, but will consider approving additional funds on an as needed basis in order to complete the engagement. We bill at a summary level, generally on a monthly basis, based on the fees and expenses incurred. Payment is due upon invoicing without regard to the current status of this matter, and a late payment fee of 1 ½ percent per month may be charged for any indebtedness. We require full payment of any indebtedness prior to the issuance of any report. We may stop work at any time in the event of any delinquency of indebtedness. We may resign this engagement at our sole discretion at any time.

The scope of this engagement does not constitute a rendering by Kroll or its employees of any legal advice, and because our engagement is limited in nature and scope it cannot be relied upon to discover all documents and other information or provide all analyses which may have importance to this matter. This engagement does not anticipate the compilation, review, or audit of financial records or financial statements. No representative of the City will hold us responsible for any loss or liability, which may result from the nondiscovery of any matters which may otherwise have an influence on this matter.

We have undertaken a limited inquiry of Kroll's records to determine if there are any conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any. However, the conflicts with this engagement, and currently we are aware not found any theorem and present clients with the conflicts with the conflicts conflicts come to our attention. In the event that additional relationships or potential conflicts come to our attention, we will promptly notify you relationships or potential conflicts come to our attention, we will promptly notify you relationships of potential conflicts come to our attention, we will promptly notify you relationships or

The Council and City agree that the City or any other party or affiliate acting on their behalf will not hold Kroll its affiliates, its representatives or its employees legally responsible for any loss or liability to the City or any of it's representative or personnel for any claims, liabilities, or expenses relating to this engagement. Additionally, the City agrees to indemnify and hold harmless, Kroll, its affiliates, its representatives and its employees from any and all claims, liabilities, or expenses arise as a result of Kroll performing services pursuant to this Agreement. This provision and other provisions in this Agreement will survive the completion or termination of this engagement.

If any portion of this Agreement is held to be void, or otherwise unenforceable, in whole or part, the remaining portions of this Agreement shall remain in effect.

Need to note which jurisdiction this contract is to be interpreted under.

We appreciate the opportunity to assist you on this matter. If this Agreement meets with your approval and your client's approval, please sign below. Please return the signed letter to Troy Dahlberg at the above address, retaining a copy for yourself and your client.

Very truly yours,

Mr. Troy Dahlberg Managing Director Kroll Inc.

EXHIBIT NO. 4



KPMG LLP Three Embarcadero Center San Francisco, CA 94111

Telephone 415 951 0100

October 11, 2004

Leslie J. Girard, Esq.
Assistant City Attorney
Office of the City Attorney
City of San Diego
1200 Third Avenue, Suite 1620
San Diego, CA 92101

RE: CITY OF SAN DIEGO FISCAL YEAR 2003 AUDIT

Dear Mr. Girard:

As shared in previous meetings and correspondence, including our letters dated August 9, 2004 and September 1, 2004, we do not believe that the City of San Diego ("City") has conducted an adequate investigation in order to conclude that likely illegal acts have not occurred, or that appropriate remedial action has been taken. Such an investigation is necessary in order for an auditor to complete an audit in accordance with generally accepted auditing standards and Government Auditing Standards.

The primary purpose of this letter is to express KPMG's position on what additional action KPMG believes the City should take relating to the investigation and remediation of potential illegal acts to enable KPMG to complete its audit of the City's basic and fund financial statements for the fiscal year ended June 30, 2003. KPMG has been concerned that the City was not undertaking an investigation specifically designed for the purpose of addressing audit responsibilities under generally accepted auditing standards and *Government Auditing Standards* relating to possible illegal acts. At the City's request, and as reflected in our September 1, 2004 letter, KPMG agreed to await the completion of the Vinson & Elkins ("V&E") report (the "Report"), to review the Report, and to advise the City as to what, if any, further information KPMG required in order to be in a position to complete its audit and issue its audit reports. As discussed, and as explained in more detail below, our overriding concern has been and remains, that an investigation must be of sufficient scope and thoroughness to provide a sound basis for concluding either that illegal acts with relevance to the City's financial reporting have not occurred or that appropriate remedial action has been taken with respect to any conduct which the City and its counsel cannot definitively conclude was legal.

At your request and to make our next meeting as constructive as possible, we have attempted in this letter to synthesize what additional action we believe the City needs to take to enable KPMG to complete its audit, and also to explain in general terms why this additional action is necessary.



Ex 4 A



BACKGROUND

We understand that the SEC is conducting a formal investigation of the City of San Diego's public disclosures relating to the SDCERS in the City's bond offerings during the period 1996 through January 2004. This investigation was commenced following the City's filing of a Voluntary Report of Information on January 27, 2004 with the Municipal Securities Rulemaking Board and the Nationally Recognized Municipal Securities Information Repositories. That Voluntary Report made new disclosures regarding the City's obligations to fund the SDCERS and also disclosed that there had been errors in the City's 2002 CAFR.

We also understand that the U.S. Attorney and FBI are conducting a criminal investigation relating to the City's pension funding and disclosures. There have also been press reports of an additional investigation by the FBI relating to possible "public corruption" issues relating to the process by which the City and SDCERS have negotiated and approved various agreements in which the City's obligations to make payments to fund SDCERS were reduced and/or deferred in exchange for agreements to increase or expand benefits.

We understand that all of these investigations are focused on the conduct of individuals who either are currently employed by the City, were employed by the City during the period covered by KPMG's ongoing audit, or were acting in some manner on behalf of the City or SDCERS during the relevant time period.¹

V&E was retained by the City and conducted an investigation into the City's disclosure practices and prepared a report. The V&E Report, which was made public on September 16, 2004, describes systemic failures in the City's financial reporting and disclosure processes related to the SDCERS pension plan. See e.g., Report at 170-171 (referring to "across the board failures of the City's internal disclosure processes.") It also reflects that, as late as the fall of 2003 the City's Disclosure Counsel thought information was being withheld from him and there were fundamental disagreements about whether acknowledged errors in the historical financial statements were material. Report at 114-120. The Report acknowledges that the City's prior SDCERS related disclosures were inadequate, and while it appears to stop short of concluding that there were material misstatements in the City's disclosures, it describes a dysfunctional disclosure system and also comments upon the City's "minimalist approach to public disclosure." Among the observations supporting this conclusion is the statement that "the City Auditor was disinclined to

¹ Potential illegal acts by SDCERS or its board are relevant to KPMG's audit. Your position (expressed in the September 20, 2004 letter), that SDCERS is an "entity independent of the City," does not address the fact that the financial condition of SDCERS is reported as a fiduciary fund in the City's CAFR.



include information in the City disclosure that reflected badly on the City and would sometimes excise negative statements from disclosure documents." Report at 117.

The V&E report includes two paragraphs under a heading "Conclusions Regarding Intent." Report at 164. These paragraphs state that because many of the "gaps" in the City's disclosures are "closed" when information in the SDCERS CAFRs is considered and because local press coverage of the pension plan highlighted many of the risks surrounding the more controversial City funding agreements (Managers 1 and 2) and the presence in the Municipal Code of the menu for distribution of surplus earnings, any attempt to conceal the SDCERS funding situation would have been an "exercise in futility."

While we understand that V&E has concluded that it has gathered sufficient evidence to support this conclusion, for purposes of our audit, we note that this conclusion does not address the questions we have posed as being important to our completion of our audit, and therefore, does not end our inquiry. Indeed at our meeting on August 27, 2004, Both the City and V&E have made it clear to KPMG that V&E was not retained to investigate issues relating to intent or whether any individual's conduct violated any law, rule or regulation, and that the scope of its investigative efforts were not designed to do so. At that meeting, we informed the City that, in the absence of conclusions on such issues, KPMG anticipated advising the City that additional investigative procedures may be necessary before KPMG would be in a position to complete its audit; and, in turn, we were advised that the City would perform any additional inquiries that KPMG believe were necessary for it to be able to conclude on issues that might affect its ability to issue an audit opinion.

Unfortunately, based upon the information we have been provided to date regarding the scope and method of the V&E investigation, we do not believe the statement in the report that "it is difficult to attribute the City's failure to fully and accurately describe [pension] matter[s] to intentional misconduct on the part of individual employees" is sufficient to resolve the issue of potential illegal acts for purposes of KPMG's audit because it is not based on an investigation that had a scope and methodology that would provide a reliable basis for reaching a conclusion as to whether City officials engaged in intentional misconduct or other conduct, which violated any law, rule or regulation having the force of law.

It is in this context and against these background facts, that KPMG's requirements, as outlined in this letter, must be understood. Most fundamentally, because there is evidence of possible illegal acts by the City or persons whose acts are attributed to it, under Generally Accepted Auditing Standards (GAAS) and Generally Accepted Government Auditing Standards (GAGAS), as well as other relevant professional guidance, to the extent the following questions are not directly



addressed in the V&E Report, additional investigative procedures are required in order to determine if illegal acts are likely to have occurred, to assess the direct or indirect effect of such acts on the City's financial statements as well as the implications for the reliability of representations being made by City employees to KPMG in the course of our audit, and to determine if any such illegal acts have been adequately remediated by the City.

The report based on such an investigation must include clear conclusions and be supported by a thorough investigation. However, as stated above, and as KPMG has been advised, the V&E investigation was not conducted as a forensic investigation, and did not result in a report that reached clear conclusions about whether federal securities laws (or any other relevant laws) had been violated, did not explore potential individual conduct that may be fraudulent or unlawful, and thus does not provide a basis for determining potential financial statement effects or determining KPMG's ability to rely on management representations from the City.

Further, the Report's discussion of certain evidence raises a concern that the investigation, for our purposes, did not adequately follow up on evidence which might suggest that certain of the deficiencies in financial reporting may have been the result of conscious efforts by one or more persons at the City. In the absence of an investigation and report that adequately explores these issues, it is not possible to determine if the City has taken appropriate remedial measures or if the representations made to us during our audit by certain individuals can be relied upon by us in reaching our opinion on the financial statements. ²

In this regard it also bears noting that the remedial measures recommended in the Report are all prospective and entail structural reforms to address the City's process of disclosure in the future. These reforms are subject to approval by the City Council and, even if adopted, would have no impact on the manner in which the City will have prepared its 2003 audited financial statements.

² See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions Exchange Act Release No. 44969, 2001 SEC LEXIS 2210 (Oct. 23, 2001), arising out of an investigation into financial reporting by Seaboard Corporation.



OVERVIEW OF RELEVANT AUDITING AND ACCOUNTING REQUIREMENTS

AICPA State and Local Audit and Accounting Guide § 4.44.

(1) Illegal Acts with Direct and Material Effects on Financial Statement Amounts

GAAS requires an auditor to plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatements arising from illegal acts that have a direct and material effect on the determination of financial statement amounts. The auditor's consideration of those potential misstatements is a matter of professional judgment and is influenced by his or her perceptions of the needs of a reasonable person who will rely on the financial statements.

The professional literature identifies the following types of legal compliance requirements as among those that may have a "direct and material" effect on the determination of financial statement amounts.

- GAAP Requirements. Governments often are subject to legal or contractual provisions that require them to prepare their financial statements in conformity with GAAP.
- Federal and State Taxes. Governments are subject to various federal tax
 requirements, including those relating to employment taxes, employee benefits,
 and tax-exempt debt (such as arbitrage rebate requirements). State-level tax
 requirements also may apply.

(2) Illegal Acts With Indirect Effects on Financial Statements

The auditing literature also recognizes that Governments often are affected by many other laws or regulations, which generally relate more to an entity's operating aspects than to its financial and accounting aspects, and that the financial statement effect of those laws and regulations is "indirect". Although an auditor is not required to plan the audit to detect noncompliance with such laws and regulations, the auditor does have certain detection, consideration, and reporting responsibilities relating to potential violations of such laws, which require the auditor to insist that when potential violations of such laws come to light, they must be investigated.

Moreover, GAAP requires a government entity, such as the City, to disclose in its financial statements material violations of finance-related legal and contractual provisions. Accordingly, the



auditor of a governmental entity is alert to the possible financial reporting effect of noncompliance with law that has a material <u>indirect</u> effect on financial statements. Because the government entity itself has financial statement reporting obligations related to violations of such laws, the government and the auditor both have a shared interest in assuring that when potential violations of such laws come to light, they are fully investigated so that the financial statements can include the GAAP³ required disclosure.

In considering whether the financial statements are free of material misstatements arising from (1) illegal acts that have a direct and material effect on the determination of financial statement amounts, or (2) illegal acts that have an indirect material effect on financial statements, the auditor should consider both quantitative and qualitative factors. Qualitative factors that the auditor may consider relevant to that evaluation include the following:

- The potential effect of the noncompliance on the government's ability to raise resources (for example, through taxes, grants, contributions, or debt or loan financings) in the future.
- The potential effect of the noncompliance on the continuation of existing relationships with vendors, employees, and elected and appointed officials.
- Whether the noncompliance involves collusion or concealment.
- Whether the noncompliance involves an activity that often is scrutinized by elected or appointed officials, citizens, the press, creditors, or rating agencies.
- Whether the fact of the noncompliance is unambiguous rather than a matter of judgment.
- Whether the noncompliance is an isolated event or instead has occurred with some frequency.

³ GASB standards require governments to disclose certain violations of compliance requirements. NCGA Interpretation 6, Notes to the Financial Statements Disclosure, paragraph 4, states that the notes to the financial statements should disclose material violations of finance-related legal and contractual provisions. In addition, material violations, or potential violations, of finance-related legal and contractual provisions should be considered for recording a loss contingency. <u>Id.</u> at § 4.48.



- Whether the noncompliance results from management's continued unwillingness to correct internal control weaknesses.
- The likelihood that similar noncompliance will continue in the future.
- The cost-benefit of establishing internal control to prevent similar noncompliance in the future.

The risk that possible undetected noncompliance would affect the auditor's evaluation.⁴

Finally, an auditor is required by applicable auditing standards to "consider the implications of an illegal act in a relation to other aspects of the audit, particularly the reliability of representations of management." AU § 317.16. In considering such issues, the auditor must be provided with sufficient information relating to the potential illegal acts to exercise professional judgment concerning the implications of a particular illegal act for the audit. Id. ("The implications of particular illegal acts will depend on the relationship of the perpetration and concealment, if any, of the illegal act to specific control procedures and the level of management or employees involved.") Our April 13, 2004 engagement letter allows KPMG to make such a determination as to the sufficiency of the investigation for audit purposes.

INFORMATION AND REOCRDS REQUESTED, NOT YET PROVIDED

There are several open items which have been promised, but not yet provided to KPMG.

- KPMG has yet to receive all V&E interview notes, memoranda and supporting documents as requested. The basis for this request is outlined in our engagement letter.
- KPMG needs information concerning the scope and status of the criminal investigation(s), which we understand V&E is not handling. We will need to speak with the attorney representing the City in those matters.

ITEMS REQUIRING RESOLUTION BY THE CITY

Based on our review of the V&E investigation and Report, and in light of the auditing standards discussed above, KPMG has attempted to synthesize the issues that remain, which must be

⁴ <u>Id</u>. at § 4.46



resolved before we are able to complete our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*. They are as follows:

- The City needs to determine whether the City's public disclosures, including its financial statements, likely violate the antifraud provisions of the securities laws (e.g., failure to disclose pension related matters) or any other Federal, State or local laws, and if so, what, if any, impact is there to the June 30, 2003 financial statement amounts and disclosures? The report from the investigation team should include clear conclusions (with adequate support for such conclusions) whether an illegal act has occurred and whether such illegal act has been timely and adequately remediated. The report and investigation must be in sufficient scope and detail to allow us to reach our own conclusions as to (i) whether it is likely that an illegal act has occurred and, if so (ii) whether any likely illegal act that is identified will have a material effect on the entity's financial statements and, if so (iii) whether timely and appropriate remedial action has been taken. Closely related to this set of issues is whether City employees or agents have engaged in fraudulent actions including concealment, related to the potential illegal acts. The City needs to investigate and determine, and report to us, the relationship of the perpetration and concealment, if any, of likely illegal acts to specific control objectives and the level of management, employees, or consultants involved.
- The scope of the investigation needs to extend to all possible illegal acts and needs to expand, as necessary, based on findings made during the investigation. In other words, the investigators should be able to pursue all evidence of possible illegal acts no matter where they may lead.
- According to the Report, retiree healthcare benefits were paid directly out of the pension system from 1983 until 1992 when a determination was made that this violated federal tax regulations. A new system was set up which was also determined to be legally flawed in 1995, which was addressed by making payments a SDCERS benefit. While the Report compiles facts relating to this violation, and concludes that the funding method was violative of federal regulations, it does not address the possible consequences of this violation. What has the city done to consider and address the financial statement impact of possible IRS sanctions, or other contingent liabilities or disclosure obligations arising from the conduct that could impact the June 30, 2003 financial statement amounts and disclosures?



The issues from our August 9, 2004 letter must be addressed (see discussion in Exhibit I)

We look forward to meeting with the City to discuss further how the City can conduct an adequate investigation in order to conclude whether it is likely or not illegal acts have occurred, or that appropriate remedial action has been taken.

Very truly yours,

KPMG LLP

Steven G. DeVetter

Partner

cc: Mr. Dick Murphy, Mayor

Mr. P. Lamont Ewell, City Manager

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Ms. Terri Webster, Acting City Auditor and Comptroller

Exhibit I

Specific Comments Regarding September 20, 2004 City Response to KPMG's August 9, 2004 Letter

Attachments:

April 13, 2204 Engagement Letter

August 9, 2004 Letter from KPMG Re: Investigation

September 1, 2004 Letter from KPMG Re: Follow-up from meeting on August 27, 2004 September 20, 2004 letter from Les Girard Re: City of San Diego Fiscal Year 2003 Audit



SPECIFIC COMMENTS REGARDING SEPTEMBER 20, 2004 CITY RESPONSE TO KPMG'S AUGUST 9, 2004 LETTER

In your letter, you conclude by stating your view that the V&E Report "is sufficiently comprehensive to allow [KPMG] to reach the conclusions necessary for compliance with Section AU§317 of the AICPA Professional Standards and for the issuance of [KPMG's] audit report." For reasons previously articulated and expanded upon below, we are unable to agree with that conclusion.

As in many aspects of auditing, the conclusions involved in determining that potential illegal acts have been adequately investigated and remediated is one that entails an auditor's exercise of judgment. However, in the instant case, we believe that the issue is sufficiently clear that an informed and diligent auditor should not conclude that the V&E report adequately addresses the issues necessary for the completion of KPMG's audit. The Report may satisfy the City's needs (a conclusion we defer to the City to make); but, without more, it does not provide a sufficient basis for KPMG to conclude that all questions necessary to the completion of the audit have been sufficiently investigated and resolved in a manner that would permit KPMG to issue an audit report.

In response to your letter, we offer the following comments.

KPMG's Question 1

Whether or not the financial statements and or the disclosures in the financial statements were intentionally misleading and, if yes, what individuals were involved and what, if any, remedial action is recommended?

City's Comment on Question 1

Your comment seems to make two essentials points. First, that with the departure of the City's prior independent auditor and the departure of the City Auditor and Comptroller, there is no need for an investigation into whether there were any intentional illegal acts relating to the City's underfunding of the SDCERS pension plan and/or financial reporting related thereto. Secondly, your comment seems to imply that the comments in the V&E Report at page 159 concerning the possible intent of City officials to allow the City to issue misleading financial disclosures should be sufficient for KPMG in the absence of KPMG's ability to cite you to investigative reports for municipal issuers or other issuers that address the issue of intent in a manner that goes beyond the V&E Report.

Response to City's Comment on Question 1

The subsequent departure of Mr. Ryan does not change the fact that, for the entire period KPMG is auditing, he was ultimately responsible for supervising the preparation of the City's financial



statements. Moreover, numerous individuals were (and remain) involved in the financial reporting process at the City, including individuals who, according to the Report, may have been involved in the disclosure deficiencies criticized by the Report.

Under AU 317.16: "The auditor should consider the implications of an illegal act in relation to other aspects of the audit, particularly the reliability of representations of management. The implications of particular illegal acts will depend on the relationship of the perpetration and concealment, if any, of the illegal act to specific control procedures and the level of management or employees involved."

Both the City and V&E have made it clear to KPMG that V&E was not retained to investigate issues relating to intent and that the scope of its investigative efforts were not designed to do so. Based upon what we have been told about the investigation, we do not believe the statement in the report that "it is difficult to attribute the City's failure to fully and accurately describe [pension] matter[s] to intentional misconduct on the part of individual employees" is one that can be relied upon to resolve the issue of potential illegal acts for purposes of KPMG's audit because it is not based on an investigation that had a scope and methodology that would provide a reliable basis for making such a conclusion.

KPMG's Questions 2

Did the City enter into any agreement, including the "Managers Two" agreement, or otherwise take any actions that resulted in the underfunding or misuse of pension funds that is a violation of State, City or other laws?

City's Comment on Question 2

Your comment on question 2 makes essentially three points. First, that the City's potential <u>liability</u> for any violations of law from the alleged underfunding of the pension plan has been dealt with through the settlement of the <u>Gleason</u> case. Second, you state that there has never been any allegation that the City's net pension obligation reported in the City's balance sheet has been misstated. And third, that based on certain legal propositions discussed in the V&E Report at page 11, the motivations of individual members of the City Council in taking certain action are not a basis upon which that action may be voided by the courts.

Response to City's Comment on Question 2

On point 1,GASB standards require governments to disclose certain violations of compliance requirements. NCGA Interpretation 6, Notes to the Financial Statements Disclosure, paragraph 4, states that the notes to the financial statements should disclose material violations of finance-related legal and contractual provisions. In addition, material violations, or potential violations, of finance-related legal and contractual provisions should be considered for recording a loss contingency. Accordingly we do not believe that only considering the loss contingency is sufficient in these circumstances. Additionally, the considerations in AU § 317.16 need to be addressed in the context of this question.



On point 2, The reported June 30, 2002 \$39 million net pension obligation was misstated due to the payment of retiree healthcare benefits from the pension plan. At KPMG's suggestion, The City has calculated the corrected June 30, 2002 net pension obligation to be \$103 million. The considerations in AU § 317.16 need to be addressed in the context of this question. The City needs to investigate and determine the relationship of the perpetration and concealment, if any, of likely illegal acts to specific control objectives and the level of management, employees, or consultants involved. For example, V&E states that a letter from the Actuary to Mike Phillips in 1998 highlights knowledge of potential errors in the financial statements that were not changed/corrected until recommended by KPMG for the June 30, 2003 financial statements:

"All these number presuppose that the 1996-97 is the first year in which the calculated actuarial contribution is greater than the actual contribution. You made an excellent point a year ago that this may not be the case. This issue may go back close to a decade after the use of 'bifurcated' rates was implemented. The case could be made that the City has a Net Pension obligation".

Finally, on point 3, while the legal proposition to which you refer, while may be relevant to whether a court will decline to question the motivation behind proper legislative action for reasons grounded in separation of powers, we do not believe that such a consideration alters the nature of the our responsibilities as the City's independent auditor, nor the need for the City to perform additional inquiry before determining whether an illegal act has (or has not) occurred, and if so, that it has been appropriately remediated.

KPMG's Questions 3

Did the SDCERS Board breach their fiduciary duty by allowing the City to underfund the plan in exchange for additional benefits for current employees and could this action have been in violation of any laws?

City's Comment on Question 3

Your comment on this item is essentially that the SDCERS board is independent of the City of San Diego and based on that you question why the actions of SDCERS or the members of its board "relate to" KPMG's audit.

Response to the City's Comment on Question 3

The basic financial statement of the City consist of (a) the primary government, (b) organizations for which the primary government is financially accountable, and (c) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete.

The definition of the reporting entity is based primarily on the notion of financial accountability. A primary government is financially accountable for the organizations that make up its legal entity. It is also financially accountable for legally separate organizations if its officials appoint a



voting majority of an organization's governing body and either it is able to impose its will on that organization or there is a potential for the organization to provide specific financial benefits to, or to impose specific financial burdens on, the primary government. A primary government may also be financially accountable for governmental organizations that are fiscally dependent on it.

The City's basic financial statements include SDCERS, and any audit opinion issued by KPMG reporting on the City's basic financial statements would, therefore, cover SDCERS. Accordingly, financial accounting and disclosure of activities occurring within SDCERS are relevant to our audit under GAAS and GAGAS.

KPMG's Question 4

Is the use of surplus earnings to pay city obligations such as benefits outside of the plan illegal?

City's Comment on Question 4

Your comment refers us to the history of the surplus earnings issue as discussed in the V&E Report.

Response to City's Comment on Question 4

According to the Report, retiree healthcare benefits were paid directly out of the pension system from 1983 until 1992 when a determination was made that this violated federal tax regulations. A new system was set up, which was also later determined to be legally flawed in 1995, which was addressed by making payments a SDCERS benefit. Report at 36. This underscores, rather than ameleorates our concerns. We must understand what the City has done to address possible IRS sanctions, and also learn what the possible impact is to the City's June 30, 2003 financial statement amounts and disclosures. Additionally, we believe that the considerations raised by AU § 317.16 need to be addressed in the context of this question.

KPMG's Question 5

Did the City violate the City Charter by failing to fund its retirement plan as required by the City Charter?

City's Comment on Question 5

Your comment on this question refers us to the fact, discussed above, that the City believes that the <u>Gleason</u> settlement "resolves the economic consequences" of the City's actions and thus, suggests that any issue with respect to whether that conduct was unlawful is irrelevant.

Response to City's Comment on Question 5

Potential liabilities are one reason violations of laws are relevant to an auditor. Because GAAP require governments to disclose material (whether quantitative or qualitative) violations of



finance-related legal and contractual provisions, the auditor of a governmental entity should be alert to the possible financial reporting effect of noncompliance that has a material indirect effect on financial statements. Additionally, KPMG believes that the considerations of AU 317.16 needs to be addressed in the context of this question.

KPMG's Question 6

Did the SDCERS Board and/or the City violate the California Constitution by allowing the City to intentionally underfund the plan?

City's Comment on Question 6

Your comments in this section refer to your earlier comments relating to Question 2 and Question 3.

Response to City's Comment on Question 6

Please see our comments above regarding these items.

KPMG's Question 7

Was undue influence placed on the actuary to change assumptions to reduce the shortfall of the City's contribution compared to the Actuarial Required Contribution (ARC), and, if yes, at whose direction and what action does the City plan to take to rectify this action, if applicable?

City's Comment on Question 7

Your comment on this item refers us to the discussion at page 91 of the V&E Report and asks for the details of any remaining concerns.

Response to City's Comment on Question 7

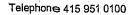
The auditor should consider the implications of an illegal act in relation to other aspects of the audit, including the reliability of representations to be obtained from members of management. The implications of particular illegal acts will depend on the relationship of the perpetration and concealment, if any, of the illegal act to specific control procedures and the level of management or employees involved.

The City needs to investigate and determine the relationship of the perpetration and concealment, if any, of likely illegal acts to specific control objectives and the level of management, employees, or consultants involved.



Other Issues Raised in the City's September 20, 2004 Letter

Your letter also commented on electronic discovery. With respect to electronic discovery, both the City and V&E have made it clear to KPMG on August 27, 2004 that V&E was not retained to investigate issues relating to intent and that the scope of its investigative efforts were not designed to do so. We believe that determining intent is required with respect to certain of the questions posed in our August 9 letter, and electronic discovery is an effective procedure in that regard, as it may provide relevant evidence for the City, its counsel, and KPMG to consider in determining whether there are unresolved questions which might affect the City's financial statements or disclosures.





Three Embarcadero Center San Francisco, CA 94111

October 29, 2004

The Honorable Dick Murphy, Mayor Mr. Lamont Ewell, City Manager City of San Diego 1200 Third Avenue San Diego, CA 92101

Gentlemen:

We write this letter in an earnest attempt to make progress with the City of San Diego towards addressing the issues that must be resolved before KPMG can complete its audit of the City's 2003 financial statements.

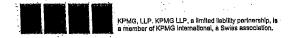
The immediate topic we must address is the letter dated October 28, 2004 from Paul Maco of Vinson & Elkins (V&E) addressed to Les Girard, Assistant City Attorney. That letter, which appears to have been posted immediately on the City's website, in our opinion seriously impairs, rather than advances, the prospects for a prompt resolution of the issues that currently stand in the way of KPMG completing its audit.

We will not in this letter seek to correct all of the statements in Mr. Maco's letter which we believe are inaccurate. However, we do wish to convey to you, as two individuals with significant responsibility for the City's affairs, several points, which are intended to be direct, but constructive:

First, KPMG cannot, and will not, complete an audit of the 2003 financial statements unless the City completes an independent investigation of potential illegal acts as we have outlined in our prior correspondence.

Second, KPMG does not seek, as Mr. Maco asserts, "broad and unspecified assurances that the City and its officials have not committed 'illegal acts.' "Nor do we request that the City retain counsel to "speculate on an unbounded universe of unasserted claims." We believe that our prior letters cannot reasonably be construed to have made such requests. To the contrary, we have laid out what our concerns are, and repeatedly advised the City's representatives that these concerns must be addressed through an investigation that was designed to develop facts that would enable the City and its counsel to address those concerns.

Third, while we believe it is somewhat unusual for an auditor to provide a detailed explanation to a client of the auditing standards that justify an auditor's request for information, we have done so here. In our correspondence, we not only discussed relevant auditing literature, but also explicated for the City some of the applicable accounting principles that require the City in its financial





The Honorable Dick Murphy, Mayor Mr. Lamont Ewell, City Manager City of San Diego October 29, 2004 Page 2

statements to make disclosures of any violations of finance-related laws and regulations. 1- We believe that the City cannot comply with this requirement unless it conducts the kind of investigation we have requested and described in our October 11, 2004 letter. Accordingly, the investigation we are requesting is one that the City ought to desire to complete so that it can discharge its own financial reporting obligations and not solely because KPMG is insisting that it do so. The City, as the issuer of its financial statements, must conclude on the question of whether any of the issues discussed in our October 11, 2004 letter and its attachments and the conduct discussed in the V&E report was illegal and, if so, whether any violations must be disclosed. and have been adequately disclosed, in the financial statements in accordance with GAAP. We would further expect the City would also determine to its satisfaction that all necessary and appropriate remedial actions have been taken with respect to conduct that is investigated. It is because it is the City's obligation to reach these conclusions that KPMG has suggested that the City obtain from its investigators sufficiently clear legal conclusions to enable the City to make the necessary determinations; we have not, as Mr. Maco suggests requested that any law firm issue a legal opinion to KPMG on any subject and his allusion to the ABA protocol for FAS 5 (Contingent Liability) attorney letters is completely off subject. It is, thus, extremely disappointing and surprising that Mr. Maco's letter so ardently contends that KPMG has not explained the auditing standards motivating its request. It is equally troubling that his letter erroneously asserts that KPMG "was not following established auditing standards."²

In light of the foregoing, and considering both that Mr. Maco may not speak for the City on these matters and that (at least according to certain press reports) there may not have been adequate communication within the City about our position, we believe that a key element of our meeting on Monday November 1, 2004 will be to secure the authoritative position of the City on these important issues. Our fundamental goal for this meeting is the same one we expressed in our letter dated October 27, 2004: "to discuss how the City plans to conduct an adequately detailed investigation that will permit KPMG to conclude its audit."

If the City is prepared to proceed with an appropriate investigation, then we urge you to consider retaining counsel other than V&E to do so. The positions asserted in, and oppositional tone of, Mr. Maco's letter raises questions about V&E's willingness or ability in these circumstances to complete the investigation of, and reach conclusions on, the audit-critical questions posed in our prior oral and written communications and to do so in an objective and independent manner. Our

In light of these requirements, the fact that the City may be exempt from Section 10A of the Securities Exchange Act of 1934 as Mr. Maco asserts, does not eliminate the City's obligations under Generally Accepted Accounting Principles ("GAAP") applicable to governments.

Again in the interest of assisting the City in understanding its obligations and explaining the professional middle of the prof

² Again, in the interest of assisting the City in understanding its obligations and explaining the professional guidance that KPMG believes is applicable here, we are enclosing a copy of a very recent Practice Alert published by the American Institute of Certified Public Accountants on "Illegal Acts".



The Honorable Dick Murphy, Mayor Mr. Lamont Ewell, City Manager City of San Diego October 29, 2004 Page 3

reading of the letter suggests to us that, at this point, conducting the kind of investigation that is necessary may be in tension with V&E's ongoing representation of the City in the pending SEC investigation.

KPMG's ability to complete its audit of the City's financial statements is dependent on resolution of these outstanding issues. We have been, and will continue, to perform the service we understood the City wanted us to perform (i.e. to objectively exercise our professional judgment in the application of professional standards). We stand ready to do so in the independent manner we believe the City, the investing public and the taxpayers expect.

Very truly yours,

KPMG LLP

Steven G. DeVetter

Haven I Sovetter

Partner

cc: Mr. Leslie Girard, Assistant City Attorney, City of San Diego

Members in Public Accounting Firms

November 2004



Practice Alert

Notice To Readers

This Practice Alert is intended to provide practitioners with information that may help them improve the effectiveness and efficiency of their engagements and practices and is based on existing professional literature, the experience of members of the Professional Issues Task Force (PTTF) and information provided by certain AICPA member firms to their own professional staff. This information represents the views of the members of the PTTF and has not been approved by any senior technical committee of the AICPA. The auditing portion of this publication is an Other Auditing Publication as defined in SAS 95. Generally Accepted Auditing Standards and is intended to provide guidance to auditors of nonissuers. Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply Statements on Auditing Standards (SASs). If an auditor applies the auditing guidance included in an Other Auditing Publication, the auditor should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of the subject audit. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA, and is presumed to be appropriate.

Illegal Acts

Introduction

In April 1988, the Auditing Standards Board issued Statement on Auditing Standards No. 54, Illegal Acts by Clients ("SAS 54"). SAS 54 prescribes the nature and extent of the consideration an independent auditor should give to the possibility of illegal acts by a client in an audit of financial statements in accordance with generally accepted auditing standards. SAS 54 also provides guidance on the auditor's responsibility when a possible illegal act is detected.

SAS 54 is the primary source of guidance with respect to the auditor's consideration of the possibility of illegal acts by a client in an audit of financial statements in accordance with generally accepted audit-

ing standards. However, auditors performing audits in accordance with Government Auditing Standards (also referred to as the "Yellow Book") should also be aware that those standards include additional requirements related to illegal acts. Auditors should refer to SAS 74, Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance, and the AICPA's Audit Guide, Government Auditing Standards and Circular A-133 Audits (which has been updated for the 2003 revisions to Government Auditing Standards), for additional information on illegal acts and the auditor's reporting. responsibilities when performing an audit under Government Auditing Standards.

SAS 54 defines illegal acts as violations

Nonissuer refers to any entity other than an "issuer." The term "issuer" is defined in Section 2 of the Sarbanes-Oxley

An issuer as defined in Section 3 of the Securities Exchange Act of 1934, the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) [of the Exchange Act] or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn. [Parenthetical references to the United States Code omitted].

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of laws or government regulations. Additionally, the AICPA's Audit Guide, Government Auditing Standards and Circular A-133 Audits, states that it generally has been interpreted under GAAS that the term laws and regulations in SAS 54 implicitly includes provisions of contracts or grant agreements. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity. Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities.

Illegal acts are divided into two categories: 1) those having a direct and material effect on financial statement amounts and 2) those having only an indirect effect on the financial statements. Some laws and regulations have a direct and material effect on financial statement amounts. For example, tax laws affect accruals and the amount recognized as expense in the accounting period; applicable laws and regulations may affect the amount of revenue accrued under government contracts. Other laws and regulations, such as occupational safety and health, food and drug administration, environmental protection, equal employment opportunity, and antitrust violations, may have only an indirect effect on the financial statements.

The auditor's responsibility for detection of illegal acts having a direct and material effect onthe financial statements

The auditor must consider laws and regulations that are generally recognized to have a direct and material effect on the financial statements. However, the auditor should consider such laws and regulations from the perspective of their known relation to audit objectives derived from financial statement assertions rather than from the perspective of legality, per se.

The auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the financial statements is the same as that for misstatements caused by error or fraud and includes assessing the risk that an illegal act may cause the financial statements to contain a material misstatement. The auditor should design the audit to provide reasonable assurance that such illegal acts will be detected. Care should be exercised in planning, performing, and evaluating the results of these procedures. The auditor's planning and risk assessment process should include consideration of the different characteristics of illegal acts and of factors indicating increased risk of illegal acts that have a direct and material effect on the financial statements.

The auditor's responsibility for detection of illegal acts having an indirect effect on the financial statements

The auditor has no direct responsibility to detect and report misstatements resulting from illegal acts having an indirect effect on the financial statements (hereafter referred to as "indirect effect illegal acts") as the auditor does not ordinarily have a sufficient basis for recognizing possible violations of laws and regulations that have only an indirect effect on the financial statements. The auditor's responsibility is limited to applying auditing procedures. to such acts that come to the auditor's attention and being aware that such acts may exist. However, if specific information comes to the auditor's attention regarding the existence of possible indirect effect illegal acts, the auditor should apply audit procedures to determine the potential effects of the possible indirect effect illegal act on the financial statements.

Audit procedures in the absence of specific information indicating the existence of possible illegal acts

The auditor should perform the audit with an attitude of professional skepticism, remaining alert to conditions or events that indicate illegal acts may have occurred. Procedures applied for the purpose of forming an opinion on the financial statements may bring possible illegal acts to the auditor's attention. Considerations as to whether an act is illegal, or of doubtful legality, are frequently outside the auditor's expertise, therefore, the auditor should consider consulting with legal counsel. Additionally, laws and regulations can also vary considerably in terms of their significance to the financial statements.

Possible illegal acts may come to the auditor's attention as a result of inquiries of management and others. The auditor is required to make inquiries of management concerning the client's compliance with laws and regulations. The auditor should also consider the need to obtain representations from the audit committee or others with equivalent authority and responsibility such as the board of directors or the owner in an owner-managed business, (hereinafter referred to as the "audit committee") and the chief legal officer that possible illegal acts brought to their attention have been communicated to the auditor.

Other inquiries may include, but are not limited to:

- Discussions with principal officers as part of the planning
- Discussions with legal counsel and others as part of the evaluation of the adequacy of the accounting for, and the need for

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whether the audit committee has been informed of the situation and is taking appropriate action to investigate the matter.

Determine whether the audit committee has been informed about the illegal act

The communications with the audit committee should describe the act and the circumstances of its occurrence, as understood by the auditor. In addition, the auditor should communicate the potential effect on the financial statements and related disclosures. The communication may be either oral or written. If the communication is oral, the auditor should document the discussion.

Client investigation of the possible illegal act

When the audit committee is informed of possible illegal acts that come to the auditor's attention, an investigation into the matter may be made by the audit committee. In certain circumstances, the auditor may insist on an investigation in order to conclude on the effect of the possible illegal act on the financial statements.

Oftentimes in conducting these investigations, the audit committee may seek assistance from outside counsel and other experts such as forensic accountants, if necessary. The auditor may consider requesting that the audit committee keep the auditor apprised of the progress of the investigation and to facilitate discussions concerning the investigation between outside counsel and the auditor.

At the conclusion of the investigation, the auditor should consider requesting that he or she attend the investigative team's presentation to the audit committee and documenting the discussion.

After the audit committee has investigated the possible illegal act and presented the scope of their procedures, their conclusions and any remedial actions to the auditor, the auditor should evaluate the conclusions and determine how they affect the audit of the financial statements. The auditor should coordinate with the appropriate level of senior management and/or the audit committee, based upon the facts and circumstances, to facilitate the auditor's consultation with the client's outside legal counsel about the legal ramifications of the possible illegal act, including, for example, whether there is a penalty which might attach to the illegal act and, if so, the amount, or whether the transaction(s) in question has significance with respect to deductibility of stated amounts for tax purposes and under "cost plus" contracts or other similar situations that apply.

Based on these discussions and the results of the investigation, the auditor should access the many first disclosures in the financial statements, communication of internal control deficiencies, and/or modifications to the audit report. Depending on the results of the investigation, the auditor may also need to consider whether to withdraw from the engagement.

If the client fails to give the occurrence of an illegal act the appropriate level of consideration or fails to take the steps deemed warranted, the auditor should consider the implications of the illegal act in relation to his or her initial evaluations and reevaluate:

- Engagement risk.
- Reliance on management's role in the functioning of internal control.
- Reliance on management's representations.
- Validity and propriety of other similar transactions.

Additionally, the auditor should consider whether any concerns might be mitigated by the performance of additional substantive audit procedures.

The auditor should be sure that the company's board of directors or audit committee is fully aware of the possible consequences of the act and has formally approved the course of action to be followed, when the circumstances so warrant.

Material illegal acts

The materiality of an illegal act cannot be appropriately assessed by considering only the quantitative effects; the auditor must also consider the qualitative effects of the illegal act. These effects may often be found to overshadow the act's immediate effect. Accounting and disclosure ramifications of loss contingencies associated with illegal acts should be considered in accordance with FASB Statement of Standards No. 5, Accounting for Contingencies. The determination of the significance of potential illegal acts will generally entail consultation with the client's legal counsel.

Immaterial illegal acts

The aggregate of all immaterial illegal acts should be evaluated in relation to the materiality level for the financial statements as a whole. The auditor should consider the effect of each individual misstatement and consider recording an individual misstatement. that has a material effect on an individual account or group of accounts, even though that individual misstatement may be offset by other unadjusted misstatements. The auditor needs to also consider the qualitative aspects of the illegal act such as how the illegal act affects the auditor's ability to rely on management representations.

Disclosure of illegal acts to third parties

Disclosure of an illegal act to parties other than the client's audit-committee is not ordinarily part of the auditor's responsibility, and such disclosure would normally be precluded by the auditor's ethical or legal obligation of confidentiality, unless the matter affects his or her opinion on the financial statements. The auditor should recognize, however, that a duty to notify parties outside the confidentiality, which is obtained that the control of the confidentiality is notify parties outside the confidentiality.

- To a successor auditor when the successor makes inquiries in accordance with AU section 315, Communications Between Predecessor and Successor Auditors. In accordance with AU section 315, communications between predecessor and successor auditors require the specific permission of the client.
- · In response to a subpoena.
- To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive finan-





cial assistance from a government agency. Government Auditing Standards state that the client may be required by law or regulation to report illegal acts to specified external parties (for example, to a federal inspector general or a state attorney general) and that if the client fails to report such acts, then the auditor should report the illegal acts directly to the external party specified in the law or regulation. Additionally, when an illegal act involves assistance received directly or indirectly from a government agency, auditors may have a duty to report it directly if management fails to take appropriate steps to remedy the illegal acts that the auditor reported to it. See Chapter 5 of Government Auditing Standards and the AICPA Audit Guide Government Auditing Standards and Circular A-133 Audits for additional guidance.

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with his or her legal counsel before discussing illegal acts with parties outside the client.

Reporting considerations

The auditor may be faced with various reporting issues as a result of becoming aware of acts that he or she suspects may be illegal. Depending upon the particular circumstances, the auditor may consider modifying the auditor's report. Such modification may result from one or more of the following considerations.

Scope limitation

Generally, the auditor should disclaim an opinion on the financial statements when precluded by the client from applying all the procedures considered necessary in the circumstances. In situations not involving a client-imposed scope restriction (e.g. appointment of the auditor after the client's physical inventory has been taken) and depending upon the auditor's assessment of the importance of the ornitted procedures, the auditor may consider qualifying the opinion or disclaiming an opinion. In the latter case, the decision should reflect the auditor's assessment of the significance of the matter to the particular entity and the pervasiveness and magnitude of the potential direct and indirect effects of the acts in question on the client's financial statements taken as a whole.

Departure from generally accepted accounting principles

When the auditor has been able to conduct the audit in accordance with generally accepted auditing standards and concludes an event or transaction has not been properly accounted for or disclosed in the financial statements, the auditor may qualify the opinion or issue an adverse opinion depending upon the magnitude of the potential effects of the event or transaction. If the departure from generally accepted accounting principles results from inadequate disclosure, the auditor's modified report should provide the information omitted by the client.

Inability to determine materiality of an illegal act

In the event that the auditor is unable to conclude as to the materiality of an illegal act, the auditor should modify his or her report or disclaim an opinion to adequately reflect the uncertainty.

Client refusal to accept report

If the client refuses to accept a report that has been modified for a client-imposed scope restriction or a departure from generally accepted accounting principles, including inadequate disclosure, the auditor should withdraw from the engagement. If a client refuses to accept a report that has been modified for other reasons, the auditor may have no alternative but to withdraw from the engagement. In any case of withdrawal, the reasons for the withdrawal should be indicated in writing to the audit committee. Deciding whether there is a need to notify parties outside the client's organization of an illegal act is the responsibility of the company's management. However, as previously indicated, the auditor may have a duty to notify parties outside the client.

Audits performed under Government Auditing Standards

Auditors performing audits under Government Auditing Standards also must issue a report on internal control over financial reporting and on compliance and other matters that reports on the scope and results of testing of the auditee's internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements. The AICPA Audit Guide, Government Auditing Standards and Circular A-133 Audits provides additional guidance on the auditor's responsibilities with regard to this report.

Documentation

The audit documentation should include appropriate documentation with respect to:

- The required inquiries related to possible illegal acts and compliance with laws and regulations.
- Company policies relative to the prevention of illegal acts, and the use of directives and periodic representations concerning compliance with laws and regulations.
- Circumstances identified that indicate the possible existence of illegal acts and conclusions reached thereon, if applicable.
- The auditor's assessment of the procedures performed by the company to determine that the illegal act was properly accounted for and disclosed, if applicable.
- Whether any uncorrected misstatements appear to represent illegal acts, if applicable.
- Written representation from management concerning the absence of violations or possible violations of laws and regulations.
- Discussions with management, the audit committee, and, if applicable, the board of directors.
- Representations from the audit committee regarding satisfactory completion of any investigations into possible illegal acts undertaken at their direction and satisfactory resolution of the matters identified in the investigation, if applicable.

Please refer to the September 16, 2004 Report on Investigation by Vinson & Elkins L.L.P., which can be found on the City of San Diego Official Website, by clicking on "More News & Announcement/Press Releases...," then "Citywide Press Releases," then "2004 Press Releases," then "Vinson & Elkins Financial Disclosure Report," or by going directly to: http://www.sandiego.gov/press/retirement040916.pdf

EXHIBIT NO. 5

EXHIBIT NO. 6

ATTORNEY TO CLIENT CORRESPONDENCE

FOR CONFIDENTIAL USE ONLY

Office of The City Attorney City of San Diego

MEMORANDUM MS 59

(619) 236-6220

DATE:

November 23, 2004

TO:

Council Member Donna Frye

FROM:

City Attorney

SUBJECT:

KPMG/Vinson & Elkins Additional Investigation

You requested a copy of the work plan for the additional investigation to be performed by Vinson & Elkins with respect to the audit by KPMG. Enclosed please find a copy of the plan, prepared by attorneys and consultants for the City and thus within the protection of the attorney work product privilege and the attorney-client communication privilege. This information is very sensitive at this time, and premature release of the work plan could frustrate the ability to timely complete it (as it would give potential subjects of the investigation advance notice of how the City intends to address certain issues or convey the plan to third parties intent on frustrating the successful completion of the audit). Such frustration of purpose could be perceived as interfering with the on-going SEC and U.S. Attorney investigations. We ask that you treat this information in the strictest confidence.

CASEY GWINN, City Attorney

Ву

Leslie J. Girard, Assistant City Attorney

Council Member Donna Frye November 23, 2004 Page 2

LJG:ljg
Enclosure
cc: Paul Maco, Esq.
Ken McNeil, Esq.
Marc Seltzer, Esq.
John Garvey

| Issue | Additional investigative procedures: | Proposed | additional |
|---|---|---------------|------------|
| | | interviewees: | |
| 1. Whether the City's disclosures violate the antifraud provisions of the applicable securities | Additional procedures will identify and address any additional potential illegal conduct of which the City is | Exhibit 1 | |
| laws? | on notice. | | |
| Whether the City's disclosures violate other laws (such as State securities laws?) | Analysis of hard drives as part of across-the-board review, as identified on Exhibit 1. Additional forensic | | |
| Did any illegal acts occur? | analysis of hard drives to be performed it interviews and/or procedures suggests it to be necessary. | | |
| Source: Letter from Steven G. DeVetter (KPMG) to Les Girard (City of San Diego) (October 11, 2004) at 8. | Additional interviews as specified in Exhibit 1. | | |
| 2. Did the scope of the investigation extend to all possible illegal acts and was it capable of | Additional procedures will identify and address any additional potential illegal conduct of which the City is | Exhibit 1 | |
| expanding based on finding made during the investigation? | on notice. | | |
| Source: Letter from Steven G. DeVetter (KPMG) to Les Girard (City of San Diego) (October 11, 2004) at 8. | Analysis of hard drives as part of across-the-board review, as identified on Exhibit 1. Additional forensic analysis of hard drives to be nerformed if interviews | | |
| | and/or procedures suggests it to be necessary. | | |
| | Additional interviews as specified in Exhibit 1. | | |
| 3. Did the investigation address the possible | V&E or another firm to provide legal analyses and | N/A | |
| violations of federal tax regulations associated with the payment of health care benefits? | opinion or other foundation for City conclusion. | | |
| Remediation? Financial statement impact? | | | |
| Source: Letter from Steven G. DeVetter (KPMG) to Les | | | |

| | Exhibit 1 | | N/A |
|---|--|---|--|
| | Additional procedures will identify and address any additional potential illegal conduct of which the City is on notice. A. Because the V&E report already covered City pension disclosure issues, additional procedures for this item will involve follow-up on information pertaining to other issues or SDCERS issues. | B-D. Analysis of hard drives as part of across-the-board review, as identified on Exhibit 1. Additional forensic analysis of hard drives to be performed if interviews and/or procedures suggests it to be necessary. Additional interviews as specified in Exhibit 1. | Additional procedures will identify and address any additional potential illegal conduct of which the City is on notice. Analysis of hard drives as part of across-the-board review, as identified on Exhibit 1. Additional forensic analysis of hard drives to be performed if interviews and/or procedures suggests it to be necessary. Luce, Forward or another firm to provide legal analysis and opinion or other foundation for City conclusion, |
| Girard (City of San Diego) (October 11, 2004) at 8. | 4. Whether or not the financial statements and/or the disclosures were intentionally misleading? If so, who was involved and what remedial action is recommended? A. City pension financial statement issues. B. SDCERS financial statement issues. | C. Non-pension City financial statement issues. D. Shipione allegations. Source: Letter from Steven G. DeVetter (KPMG) to Les Girard (City of San Diego) (August 9, 2004) at 3; see also Letter from Steven G. DeVetter (KPMG) to Les Girard (City of San Diego) (October 11, 2004) Exhibit I at 1-2. | 5. Did the City enter any agreement, including MP2, or otherwise take any actions that resulted in underfunding or misuse of pension funds that is a violation of State, City, or other laws? Source: Letter from Steven G. DeVetter (KPMG) to Les Girard (City of San Diego) (August 9, 2004) at 3; see also Letter from Steven G. DeVetter (KPMG) to Les Girard (City of San Diego) (October 11, 2004) Exhibit I at 2. |

| | /sis N/A | nny Exhibit 1. r' is ard sic sic ws |
|---|---|---|
| | Luce, Forward or another firm to provide legal analysis and opinion or other foundation for City conclusion. | Additional procedures will identify and address any additional potential illegal conduct of which the City is on notice. Analysis of hard drives as part of across-the-board review, as identified on Exhibit 1. Additional forensic analysis of hard drives to be performed if interviews and/or procedures suggests it to be necessary. |
| Girard (City of San Diego) (August 9, 2004) at 3; see also Letter from Steven G. DeVetter (KPMG) to Les Girard (City of San Diego) (October 11, 2004) Exhibit I at 4. | 9. Did the SDCERS Board and/or the City violate the California Constitution by allowing the City to intentionally underfund the plan? Source: Letter from Steven G. DeVetter (KPMG) to Les Girard (City of San Diego) (August 9, 2004) at 3; see also Letter from Steven G. DeVetter (KPMG) to Les Girard (City of San Diego) (October 11, 2004) Exhibit I at 5-6. | 10. Was undue influence placed on the actuary to change assumptions to reduce the shortfall of the City's contribution compared to the ARC and, if yes, at whose direction and what action does the City plan to take to rectify this action? Source: Letter from Steven G. DeVetter (KPMG) to Les Girard (City of San Diego) (August 9, 2004) at 3; see also Letter from Steven G. DeVetter (KPMG) to Les Girard (City of San Diego) (October 11, 2004) Exhibit I at 6. |

| | including on issues related to the Gleason settlement. | - | |
|--|--|---------------------|--------------|
| 6. Did the SDCERS Board breach their | Additional procedures will identify and address any | Additional | interviews |
| fiduciary duty by allowing the City to | additional potential illegal conduct of which the City is | with members of the | s of the |
| | on notice. | SDCERS B | Board or |
| benefits for current employees and could this | | other | SDCERS |
| action have been in violation of any laws? | Interviews of additional SDCERS personnel and review | personnel. | |
| | of additional documents from SDCERS, including DPC | | |
| Source: Letter from Steven G. DeVetter (KPMG) to Les | electronic documents. | | |
| Girard (City of San Diego) (August 9, 2004) at 3; see | | | |
| aiso Letter from Steven G. DeVetter (KFMG) to Les Girard (City of San Diego) (October 11, 2004) Exhibit I | Analysis of hard drives as part of across-the-board | | |
| at 3. | review, as identified on Exhibit 1. Additional following | | |
| | analysis of nard drives to be performed it miteraters | | |
| | and/or procedures suggests it to be necessary. | | |
| | Ince Forward or another firm to provide legal analysis | | |
| | and opinion or other foundation for City conclusion. | | |
| | The state of the s | | |
| 7. Is the use of surplus earnings to pay city | Luce, Forward or another firm to provide legal analysis | N/A | |
| obligations such as benefits outside of the plan | and opinion or other foundation for City conclusion. | | |
| illegal? | | | |
| | | | |
| Source: Letter from Steven G. DeVetter (KPMG) to Les | | | |
| Girard (City of San Diego) (August 9, 2004) at 3; see | | | |
| aiso Letter from Sieven G. Devetter (N. 140) to Les Girard (City of San Diego) (October 11, 2004) Frhihit I | | | |
| of 4 | | , | |
| | | | |
| 8. Did the City violate the City Charter by | Luce, Forward or another firm to provide legal analysis | N/A | |
| failing to fund its retirement plan as required | and opinion or other foundation for City conclusion. | | |
| by the City Charter? | | | : |
| Common Totton Low Common Common D. W. start (NYD) 101 12. 1 | | | |
| DOULTE. LETTER JOHN STEVEN G. LIEVETTER (A.F.M.G.) 10-LESS | | | |

| proposed additional interviews: Luce, Forward or another firm to pr legal analysis and opinion or foundation for City conclusion. Analysis of hard drives as part of act the-board review, as identified on Exhi Additional forensic analysis of hard of to be performed if interviews a procedures suggests it to be necessary. Follow up on additional information, is during additional interviews as identifit Exhibit 1. Renew requests for interviews individuals who were unavailable declined to participate, such as I Shipione. N/A | Initial Response: |
|--|-------------------|
| has concluded that the deficit, while Luce, Forward or another firm to pribly tributable to underfunding, was also the factors, such as use of the "surplus concept. The Waterfall approach to benefits has a negative impact on system the-board review, as identified on Exhibit 1. Follow up on additional information, if during additional interviews a sidentific benefits has a negative impact on system to be performed if interviews a procedures suggests it to be necessary. Follow up on additional information, if during additional interviews as identific benefits any specific declined to participate, such as I Shipione. WAA Renew requests for interviews individuals who were unavailable declined to participate, such as I Shipione. N/A Shipione. | |
| Analysis of hard drives as part of acthe-board review, as identified on Exhi Additional forensic analysis of hard of to be performed if interviews a procedures suggests it to be necessary. Follow up on additional information, it during additional interviews as identified. Renew requests for interviews individuals who were unavailable declined to participate, such as I Shipione. N/A | The City |
| Analysis of hard drives as part of acthe-board review, as identified on Exhi Additional forensic analysis of hard to be performed if interviews a procedures suggests it to be necessary. Follow up on additional information, it during additional interviews as identifie Exhibit 1. Renew requests for interviews individuals who were unavailable declined to participate, such as I Shipione. N/A | esult of |
| Analysis of hard drives as part of at the-board review, as identified on Exhibitional forensic analysis of hard to be performed if interviews a procedures suggests it to be necessary. Follow up on additional information, if during additional interviews as identific Exhibit 1. Renew requests for interviews individuals who were unavailable declined to participate, such as I Shipione. N/A | sarning |
| Additional forensic analysis of hard of to be performed if interviews a procedures suggests it to be necessary. Follow up on additional information, if during additional interviews as identific Exhibit 1. Renew requests for interviews individuals who were unavailable declined to participate, such as I Shipione. N/A | conting |
| to be performed if interviews a procedures suggests it to be necessary. Follow up on additional information, it during additional interviews as identification in the series of the ser | funding. |
| procedures suggests it to be necessary. Follow up on additional information, in during additional interviews as identiff. Exhibit 1. Renew requests for interviews individuals who were unavailable declined to participate, such as I Shipione. N/A | |
| Follow up on additional information, in during additional interviews as identiffication of the series of the serie | |
| | ř |
| Exhibit 1. Renew requests for interviews individuals who were unavailable declined to participate, such as I Shipione. N/A | |
| Renew requests for interviews individuals who were unavailable declined to participate, such as I Shipione. | |
| individuals who were unavailable declined to participate, such as Di Shipione. | |
| declined to participate, Shipione. N/A | 1 |
| | |
| | |
| illegal act, the City agrees that it did not its pension plan to cover the costs of the anted in 1996-2002. | Although |
| its pension plan to cover the costs of the anted in 1996-2002. | otential |
| anted in 1996-2002. | fully fun |
| _ | enefits |

¹ Many of the statements made by Diann Shipione in her various letters are factual statements that do not appear to require further investigation – for example, her statement that the SDCERS "funding ratio was 68% with a UAAL of \$720 million" is taken from the actuarial valuation reports and is not in dispute. See Letter from Diann Shipione (CERS Trustee) to Lamont Ewell (Assistant City Manager, City of San Diego) (December 31, 2002) at 1. This document does not summarize such statements, but only those allegations that, on their face, appear to potentially require further investigation.

| | or example, N/A lministering t-retirement | | any specific N/A (us earnings 8% return | | | | liabilities as N/A the structure ccounts were | SDCERS was in the tt liabilities | been done. |
|----------------------------------|--|---|--|--|-------------------|---|---|---|--|
| | This is not accurate; San Diego County, for example, uses the "surplus earnings" concept in administering its plan, including the payment of post-retirement | nealth benefits. | Although this statement does not identify any specific potential illegal act, the diversion of surplus earnings could be viewed as inconsistent with the 8% return | assumption. | | | The treatment of certain Corbett liabilities as contingent is open to interpretation, but the structure and functions of the SDCERS reserve accounts were | not hidden and were disclosed in the SDCERS CAFR. The V&E report concluded that it was in the best interest of the City to have the Corbett liabilities | computed as part of the UAAL, which has been done. |
| Diego) (December 31, 2002) at 2. | 3. No other large public retirement systems have intentionally underfunded the pension program. | Source: Letter from Diann Shipione (CERS Trustee) to Lamont Ewell (Assistant City Manager, City of San Diego) (December 31, 2002) at 2. | 4. The use of "cash basis" accounting in the municipal code is incorrectly applied to net realized gains, which diverts assets during | good earnings years and leaves no cushion during bad earnings years. The diversion of "surplus earnings" erodes the actuarial return | assumption of 8%. | Source: Letter from Diann Shiptone (CEKS Trissee) to Lamont Ewell (Assistant City Manager, City of San Diego) (December 31, 2002) at 3. | 5. Certain liabilities are hidden as "contingent" in off-the-books "reserve" accounts. | ione (CERS Trustee) Manager, City of San | Diego) (December 51, 2002) at 3. |

² See V&E Report, at 5 n.9.

| 6. The City obtained a "contribution | While Ed Ryan, for one, proposed asking for a | N/A |
|---|--|---|
| holiday, from CERS in 1995. This was done over objections that this was misuse of | contribution holiday, interviews and review of the City financial statements for 1995 and 1996 | |
| surplus earnings and inconsistent with the | onstrate that this did not occur. | |
| City Charter. | statement does not require factual investigation. | |
| Source: Letter from Diann Shipione (CERS Trustee) | | |
| to Lamont Ewell (Assistant City Manager, City of San Diego) (December 31, 2002) at 3 | | |
| (c) | | |
| 's Proposal | The City has concluded that MP 1 did allow payment | Forward or another firm to pr |
| | of less than the full ARC, this arrangement was | legal analysis and opinion of outer |
| | contingent on benefit increases, and the decision not | foundation for City conclusion. |
| | to fully fund the benefits granted at the time of MP 1 | TOO CAROL TO THE TOTAL TO THE TOTAL |
| City did not pay for. This was done over | would require payment by future taxpayers. | Analysis of hard drives as part of across- |
| objections that the plan was inconsistent with | | the-board review, as identified on Exhibit 1: |
| the City Charter and pushed the costs on to | | Additional lorensic alians of man differences |
| future taxpayers. | | > |
| Comon Lottor from Diana Chinican (CEDS Printed) | | |
| to Lamont Ewell (Assistant City Manager, City of San | | Follow up on additional information, if any, |
| Diego) (December 31, 2002) at 4. | | during additional interviews as identified on |
| | | Exhibit 1. |
| | | • |
| | | quests for interviews fro |
| | | unavailab |
| | | declined to participate, such as Diann |
| | | Shipione. |
| | | |
| - | | N/A |
| the Corbett settlement, but "to mask the | and there is some question as to whether or not these | |
| | benefits can be considered contingent. The V&E | |
| ┨ | ŀ | |

| | Analysis of hard drives as part of across-the-board review, as identified on Exhibit 1. Additional forensic analysis of hard drives to be performed if interviews and/or procedures suggests it to be necessary. | Follow up on additional information, if any, during additional interviews as identified on Exhibit 1. | Renew requests for interviews from individuals who were unavailable or declined to participate, such as Diann Shipione. | N/A |
|--|--|---|---|--|
| report concluded that it was in the best interest of the City to have the Corbett liabilities computed as part of the UAAL, which has been done. | Both the fiduciary counsel and the actuary ultimately approved MP II, after certain changes were made to the initial proposal. | | | Although this statement does not identify any specific potential illegal act, the MP II agreement retained the 82.3% floor but altered the consequences of falling below that floor and removed some of the other requirements that would have been required under some interpretations of MP I. |
| benefit the liability was labeled 'contingent'" through the use of surplus earnings to pay this benefit. Corbett is not contingent, however, because it accrues in years that it is not paid, and the City has always known this. Source: Letter from Diann Shipione (CERS Trustee) to Lamont Ewell (Assistant City Manager, City of San Diego) (December 31, 2002) at 6. | 9. MP II was approved over the strong objections of both the actuary and fiduciary counsel. Source: Letter from Diam Shipione (CERS Trustee) to Lamont Ewell (Assistant City Manager, City of San | Diego) (December 31, 2002) at 7. | | 10. MP II is flawed because it removes the 82.3% floor, removes the requirement to reach full EAN funding by 2009, and excludes significant unfunded liabilities to inflate the funding ratio. Source: Letter from Diann Shipione (CERS Trustee) |

| | not identify any specific N/A gures were disclosed in re on January 27, 2004. son settlement, the City ough pension obligation set. | | not identify any specific Analysis of hard drives as part of acrosslear to what extent the the-board review, as identified on Exhibit 1. MP II, because many Additional forensic analysis of hard drives the SDCERS Board to be performed if interviews and/or procedures suggests it to be necessary. It they were subject to procedures suggests it to be necessary. Rollow up on additional information, if any, during additional interviews as identified on Exhibit 1. Review additional City Council documents. Renew requests for interviews from individuals who were unavailable or declined to participate, such as Diann Shipione. |
|--|--|---|---|
| | Although this statement does not identify any specific potential illegal act, these figures were disclosed in the City's Voluntary Disclosure on January 27, 2004. Adjusted in part by the <i>Gleason</i> settlement, the City intends to further address through pension obligation bonds once the audit is in place. | | Although this statement does not identify any specific potential illegal act, it is unclear to what extent the benefits were conditioned on MP II, because many people disagree, many on the SDCERS Board perceived that it was and that they were subject to pressure due either to the linkage or the perceived linkage. |
| to Lamont Ewell (Assistant City Manager, City of San Diego) (December 31, 2002) at 7. | when the funding ratio will fall to 52% and contributions will be more that \$250 million the C per year. By 2009, UAAL will be \$2.8 Adju billion and contribution rates at 40% of ponding payroll. | Source: Letter from Diann Shipione (CERS Trustee) to Lamont Eyell (Assistant City Manager, City of San Diego) (December 31, 2002) at 8. | 12. The 2002 benefit enhancements were "conditioned" on contribution relief. Despite pote the City's official position, MP II bene contribution agreement and benefit peopenhancements were linked. Source: Letter from Diann Shipione (CERS Trustee) pres to Lamont Evell (Assistant City Manager, City of San Diego) (December 31, 2002) at 9. |

| deleting language regarding actuarial evaluation driving contributions, and replacing it with "pursuant to a MOU." This conflicts with the City Charter | addressed by additional inquiry. | foundation for City conclusion. |
|---|---|--|
| | | |
| | The City is aware of no evidence that fiduciary counsel objected to the indemnity agreement, but this issue will be investigated further. | Analysis of hard drives as part of across-the-board review, as identified on Exhibit 1. Additional forensic analysis of hard drives to be performed if interviews and/or procedures suggests it to be necessary. |
| | | Follow up on additional information, if any, during additional interviews as identified on Exhibit 1. |
| | | Renew requests for interviews from individuals who were unavailable or declined to participate, such as Diann Shipione. |
| | | N/A |
| 7 7 7 | and disclosures. The use of surplus earnings was the primary cause of the underfunding, with MP I and MP II contributing to the deficit. | |

| III. | Luce, Forward or another firm to provide legal analysis and opinion or other foundation for City conclusion. | c Additional interviews with members of the SDCERS Board of Administration. e e | n N/A |
|--|--|--|--|
| The City has not found any evidence to date of an intentional effort to present the City's financial condition falsely, and the condition was correctly described in the Voluntary Disclosure. | The outside professionals ultimately determined that MP II was acceptable, if not ideal. Allegations regarding California law will be addressed through additional inquiry. | Although this statement does not identify any specific potential illegal act, this alleged "conflict" was created by the City Charter and there is a history of advisory opinions on this issue. The voters of the City of San Diego approved a resolution correcting this issue on a going forward basis. | Although this statement does not identify any specific potential illegal act, the switch from EAN to PUC in 1991 was designed to reduce the City's contributions. PUC, it should be noted, is approved by GASB, and provides a lower figure for UAAL than, for instance, the EAN method would. |
| | 16. The MP II agreement was opposed by outside experts and may contravene California law providing retirees with a "vested right" in a sound pension system. Source: Letter from Diann Shipione (CERS Trustee) to Lamont Ewell (Assistant City Manager, City of San Diego) (December 31, 2002) at 11. | 17. The CERS Board is filled with members that have conflicting interests in its decisions. Source: Letter from Diann Shipione (CERS Trustee) to Lamont Ewell (Assistant City Manager, City of San Diego) (December 31, 2002) at 12 | 18. The 1991 conversion from EAN to PUC was designed to increase the funding ratio; PUC is less accurate. Postponing EAN is "funny accounting." Source: Letter from Diam Shipione (CERS Trustee) to Lamont Ewell (Assistant City Manager, City of San Diego) (December 31, 2002) at 3, 12. |

| - | N/A | | | | | | | | | | | | | | N/A | | | | | | | | | | | | N/A | | | |
|---|--|--|---|---|--|---|--|--------------------------------|--|---|--|---|----------------------|---|--|--|---|---|---|---|---|---|--|--|--|--|-----|---|---|--|
| | 4 | potential illegal act, the Waterfall approach to | contingent benefits has a negative impact on system | funding. Retiree health benefits, it should be noted, | are not part of the UAAL and are not currently | required to be disclosed in the City's financial | ements. | | The V&E report noted that the treatment of part of | the Corbett benefits as contingent is open to question, | and that it was in the best interest of the City to have | the Corbett liabilities computed as part of the UAAL, | which has been done. | 2 | Although this statement does not identify any specific | potential illegal act, the funding of CERS did not use | one of the GASB-approved funding methods, which | is why it reported an NPO. The PUC cost method, | which is an acceptable actuarial method, provides a | lower figure for UAAL than, for instance, the EAN | method would. | | The non-GASB nature of the funding mechanism was | disclosed in a footnote to the financial statements. | The SDCERS actuary had consented to the footnote | disclosure on this issue until 2002, but not thereafter. | | specific potential illegal act, and this an issue | exclusively related to the CERS Board that does not | implicate the City's financial statements and requires |
| | 19. UAAL is understated because "large | unfunded liabilities are not carried on the | books", such as Corbett, retiree health | benefits, 13th check, etc. | | Source: Letter from Diann Shipione (CERS Trustee) | to Lamont Ewell (Assistant City Manager, City of San Diego, (Dagger, 21, 2002), 4-12 | 2008 (December 31, 2002) W 12. | | | | | | | 20. CERS does not use one of the "GASB | approved" actuarial funding methods, PUC | favorably distorts the Plan's financial | condition, and no audit has been done. | | Source: Letter from Diann Shipione (CERS Trustee) | to Lamont Ewell (Assistant City Manager, City of San Diecol (December 31, 2002) at 13 | (1) (1) (1) (1) (1) (1) (1) (1) (1) (1) | | | | | | | | exercise due diligence over hiring investment |

| consultants, etc. | no further factual analysis. | | | | |
|--|--|-----|-----|-----------|---|
| Source: Letter from Diann Shipione (CERS Trustee) to Mayor Dick Murphy (May 23, 2002). | | | | . 4 5.0 | , |
| 22. Underfunding violates recommendations | Although this statement does not identify any specific | N/A | | | |
| made by GFOA. | potential illegal act, underfunding of pensions is not an optimal practice. But the GFOA guidance on "best | | | | |
| Source: Letter from Diann Shipione (CERS Trustee) to Mayor Dick Murphy (November 18, 2002) at 3. | practices" is non-binding and does not have the force of law. This issue does not require further | | | | |
| | estigation. | | · · | | |
| 23. The City Council members may have | | N/A | | | |
| personal exposure for voting for MP II. | allegations, and to the extent it is on an individual basis, it does not implicate the City's financial | | | ; ;= 1 | 4 |
| Source: Letter from Diann Shipione (CERS Trustee) | statements. This issue does not require further | | | | |
| o mayor when find (November 10, 2002) ur a. | investigation. | | | • | |
| 24. The pension deficit will become greater | | N/A | | | |
| than the City's hard assets, which will need | potential illegal act, the projected deficit was | | | | |
| to be sold to pay for these obligations. | disclosed by the City in the January 27, 2004 | | | | |
| Source: Diann Shipione (CERS Trustee), Union | voluntary Disclosure. These projected consequences are the speculative statement of opinion by a single | | * | | - |
| Iribune Op-Ed (April 9, 2003). | individual who is not involved in the City budgeting | | | | |
| | process. This issue does not require further | | | | |
| | investigation. | | | | |
| 25. "SDCERS openly acknowledges that | Although this statement does not identify any specific | N/A | • | - - | |
| GASB." | potential illegal act, the City and SDCERS illiancials one-nly disclosed this in a footnote prepared by City | | | | |
| | Oponiy disclosed diis in a rectice prepare of early | | | | |
| | | | | | |

| Source: Letter from Diann Shipione (CERS Trustee) | staff and the independent auditor, and confirmed by | |
|--|---|---|
| to Jess E. Van Devanter (September 7, 2003). | the SDCERS Actuary. | |
| | | |
| 26. Purchase of service credit liability of \$77 | | Analysis of hard drives as part of across- |
| million was hidden until 2002 valuation. | | the-board review, as identified on Exhibit 1. |
| | | ~ |
| Source: Letter from Diann Shipione (CERS Trustee) | | to be performed if interviews and/or |
| to Fred Pierce (September 7, 2003). | | procedures suggests it to be necessary. |
| | | 3 . I |
| | | Follow up on additional information, it any, |
| | | uning additional mich views as additional on |
| | | Exhibit 1. |
| | | • |
| | | Renew requests for interviews from |
| | | individuals who were unavailable or |
| | | declined to participate, such as Diann |
| | | Shipione. |
| | | |
| 27. CERS altered numbers in the Rules | The available documents reflect a dispute on this | N/A |
| Committee presentation to understate | point, but there is no evidence of any illegal act by | |
| liabilities. | the City. | |
| E CALLEY. | | |
| Source: Letter from Diann Shipione (CERS Trustee) to Fred Pierce (September 7, 2003) | | |
| | | |
| 28. CERS failed to disclose the "one-year | There is a one-year lag in the actuarial valuation used | N/A |
| deficient contributions on vice in pay its already | innest of the finding annears, but this did not | |
| delicient continuations one year in affeats. | impacts of the funding approach, but this and not | |
| Source: Letter from Diann Shipione (CERS Trustee) | impact the City financial statements. | |
| | | |

³ See &E Report at 64-65.

| to Fred Pierce (September 14, 2003). | | |
|--|---|---|
| 29. Transfers into the General Fund from the | This is an allegation made after the V&E Report was | Luce, Forward or another firm to provide |
| City's enterprise funds or other special use | completed, and as a result was outside its scope. | legal analysis and opinion or other |
| funds need to be audited to confirm that these | | foundation for City conclusion. |
| revenue sources are legitimate and | | |
| and comply with applicable la | | Analysis of hard drives as part of across- |
| | | the-board review, as identified on Exhibit 1. |
| Source: Memorandum from Diann Shipione (CERS | | Additional forensic analysis of hard drives |
| Trustee) to Steve DeVetter (KPMG) (October 29, | | to be performed if interviews and/or |
| 2004). | | procedures suggests it to be necessary. |
| | | |
| | | Follow up on additional information, if any, |
| | | during additional interviews as identified on |
| | | Exhibit 1 |
| | | |
| | | Renew requests for interviews from |
| | | ials who were unavailable |
| | | participate, |
| | | |
| | | |
| 30. The City's practice of charging water | This is an allegation made after the V&E Report was | V&E or another firm to provide legal |
| service rates based upon maintaining | completed, and as a result was outside its scope. | opinion or other foundation for City |
| | | conclusion. |
| Stabilization Fund is highly controversial and | | |
| may not comply with state law. | | |
| | | |
| | | |
| Trustee) to Steve DeVetter (KPMG) (October 29, | | |
| 2004). | | |
| 31. The City admits that it does not comply | This is an allegation made after the V&E Report was | Luce, Forward or another firm to provide |
| | | |

| legal analysis and opinion or other foundation for City conclusion. | Analysis of hard drives as part of across- | the-board review, as identified on Exhibit 1. Additional forensic analysis of hard drives to be nerformed if interviews and/or | procedures suggests it to be necessary. Follow up on additional information, if any, | during additional interviews as identified on Exhibit 1. Renew requests for interviews from | uals who were d to participate, | Shipione. | Luce, Forward or another firm to provide legal analysis and opinion or other foundation for City conclusion. | Analysis of hard drives as part of across-the-board review, as identified on Exhibit 1. Additional forensic analysis of hard drives | to be performed if interviews and/or procedures suggests it to be necessary. | Follow up on additional information, if any, during additional interviews as identified on Exhibit 1. |
|---|--|---|---|--|------------------------------------|-----------|---|--|--|---|
| completed, and as a result was outside its scope. | | | | | | | This is an allegation made after the V&E Report was completed, and as a result was outside its scope. | | | |
| with State law requirements when it increased water rates in FV 2002-2003 and | may be challenged for future rate increases in FY 2004-2006. | Source: Memorandum from Diann Shipione (CERS Trustee) to Steve DeVetter (KPMG) (October 29, | 2004). | | | | 32. The City has recognized in the past, though not necessarily in its financial statements, the likelihood that the sums | collected, if challenged in court, would be ordered returned as an illegal disguised tax. Source: Memorandum from Diama Shinione (CERS) | | |

| | <u> </u> | | | | | • |
|---|---|--|---|--|--|--|
| Renew requests for interviews from individuals who were unavailable or declined to participate, such as Diann Shipione. | - | procedures suggests it to be necessary. Follow up on additional information, if any, during additional interviews as identified on Exhibit 1. | Renew requests for interviews from individuals who were unavailable or declined to participate, such as Diann Shipione. | V&E or another firm to provide legal analysis and opinion or other foundation for City conclusion. Analysis of hard drives as part of across- | the-board review, as identified on Exhibit 1. Additional forensic analysis of hard drives to be performed if interviews and/or procedures suggests it to be necessary. | Follow up on additional information, if any, during additional interviews as identified on |
| | This is an allegation made after the V&E Report was completed, and as a result was outside its scope. | | | This is an allegation made after the V&E Report was completed, and as a result was outside its scope. | | |
| | 33. The City does not provide accurate payroll data. Artificial manipulation of payroll numbers could result in intentional underfunding of the pension plan. | Source: Memorandum from Diann Shipione (CERS Trustee) to Steve DeVetter (KPMG) (October 29, 2004). | | 34. The SDCERS independent consultant, Mercer, noted that the City may not be paying the appropriate Medicare tax on the pickup contribution. | Source: Memorandum from Diann Shipione (CERS Trustee) to Steve DeVetter (KPMG) (October 29, 2004). | |

| Exhibit 1. | Renew requests for interviews from | individuals who were unavailable or | declined to participate, such as Diann | Shipione. | Verify previous corrective action. | Analyzeis of hard drives as nart of across- | the-board review, as identified on Exhibit 1. | Additional forensic analysis of hard drives | to be performed if interviews and/or | procedures suggests it to be necessary. | Follow up on additional information, if any, | during additional interviews as identified on | Exhibit 1. | Renew requests for interviews from | were unavailab | declined to participate, such as Diann | Shipione. | ther firm to p | legal analysis and opinion or other | issues related to the <i>Gleason</i> settlement. | Analysis of hard drives as nart of across- | the-board review, as identified on Exhibit 1. Additional forensic analysis of hard drives |
|------------|------------------------------------|-------------------------------------|--|-----------|---|---|---|--|--------------------------------------|---|--|---|------------|------------------------------------|----------------|--|-----------|---|---|--|--|---|
| | | | | | The City believes that this issue has been corrected. | | | | | | | | | | | | | This is an allegation made after the V&E Report was | completed, and as a result was outside its scope. | | | |
| | | | | | 35. The City and CERS have been paying | pension benefits to deceased individuals. | Source: Memorandum from Diann Shipione (CERS | Trustee) to Steve DeVetter (KPMG) (October 29, | 2004). | | | | | | | | | 36. The City "back-loads" pension | ding through manipula | payroll data and the recent Gleason settlement. | Source: Memorandum from Diann Shinione (CERS | |

| to be performed if interviews and/or procedures suggests it to be necessary. | Follow up on additional information, if any, during additional interviews as identified on | Exhibit 1. | who were unavailable | declined to participate, such as Diann Shipione. | Interview outside auditing firm. | | | Consult with SDCERS on necessity and/or status of IRS application. | | | Verify corrective action. | | | |
|--|--|------------|----------------------|--|--|--------|---|--|---|---|---|--|---|---|
| | | | | | This statement does not identify any specific potential illegal act, and is not relevant to the City's | audit. | | This statement does not identify any specific potential illegal act, and is not relevant to the City's | audit. | | The City believes that the health care benefit has not heen noid from the 401(a) trust for many years and | the City took corrective action to address this issue in | 1996, including an amendment to the City Charler. This action was approved by SDCERS counsel. | · |
| 2004). | | | | | 37. CERS has never been comprehensively audited. | | Trustee) to Steve DeVetter (KPMG) (October 29, 2004). | 38. CERS has never applied for or received an IRS determination on its tax-qualified | Status and 10t DKOP. Source: Memorandum from Diann Shipione (CERS) | Trustee) to Steve DeVetter (KPMG) (October 29, 2004). | 39. CERS makes payments out of the 401(a) trust for other than neuring benefits and | there has no determination that payments for | itealin care can be paid in this manner. | Source: Memorandum from Diann Shipione (CERS) |

| Trustee) to Steve DeVetter (KPMG) (October 29, | | |
|--|---|----------------------------------|
| 2004). | | |
| 40. The City and SDCERS allow private | | Consult with SDCERS on status of |
| sector employees to participate in the public | | payments. |
| pension system it they are labor union presidents. | | |
| *************************************** | | |
| Source: Memorandum from Diann Shiptone (CERS | | |
| Trustee) to Sieve Devetier (ALIMO) (October 23, 2004). | | |
| | | |
| 41. The City and SDCERS allow vesting This s | This statement does not allege any illegal act. | N/A |
| after 4-10 years of service. | | |
| Source: Memorandum from Diann Shipione (CERS | | |
| Irustee) to Sieve DeVetter (KPMG) (October 29, 2004) | | |
| | | |
| | | |

report of stale information concerning the views of the SDCERS actuary on the novel approach adopted for System funding. Counsel insisted on additional due diligence before approving the offering. In the resulting review, the City's internal and external auditors discovered errors throughout the footnotes to the City's financial statements for fiscal year 2002. Although there is no reason to believe that any of these largely random and (judged from their effect on the City's balance sheet) immaterial errors were intentional, the volume of mistakes raised serious questions about the efficacy of the City's internal controls for financial reporting. As noted above, on January 27, 2004, the City provided detailed public disclosure of these errors and an exposition on the funded status of SDCERS, correcting certain omissions in the City's previous disclosure.

Based upon our investigation, we conclude that the City's procedures, policies and practices for disclosure and financial reporting are inadequate in major respects. Undermining the reliability of its public disclosure have been, among other factors, the City's excessive reliance on outside professionals to generate its disclosure documents, its lack of procedures to verify the accuracy of those documents and the absence of high-level oversight to judge the clarity and completeness of information provided to the investment markets. More generally, City administration had adopted a minimalist approach to public disclosure, providing the public with negative information only when it has felt legally required to do so. The result has been a series of damaging revelations, made without advance warning and in a manner allowing the City to have limited control over the way in which the information is interpreted. This, in turn, has led to a decline in trust between the City and the investment markets that must be carefully addressed to restore to the City its former reputation as among the most financially solid and reliable of California municipalities.

Please refer to the 2005 City Attorney's Interim Report #1, which can be found on the City of San Diego Official Website, by clicking on "City Attorney," and is listed under "City Attorney Releases Special Reports," or by going directly to: http://genesis.sannet.gov/infospc/templates/attorney/pdf/interim_report_01_14_05.pdf

Please also refer to the 2005 City Attorney's Interim Report #2, which can be found on the City of San Diego Official Website, by clicking on "City Attorney," and is listed under "City Attorney Releases Special Reports," or by going directly to: http://genesis.sannet.gov/infospc/templates/attorney/pdf/secondinterimreport.pdf

Please also refer to the 2005 City Attorney's Interim Report #3, which can be found on the City of San Diego Official Website, by clicking on "City Attorney," and is listed under "City Attorney Releases Special Reports," or by going directly to: http://genesis.sannet.gov/infospc/templates/attorney/pdf/thirdinterimreport.pdf

EXHIBIT NO. 8

EXHIBIT NO. 11

Pension investigators criticized anew | Firm is seeking more legal help; [1,6,7 Edition]

Philip J. LaVelle. The San Diego Union - Tribune. San Diego, Calif.: Apr 23, 2005. pg. B.2.1.7 Abstract (Document Summary)

Yesterday [Michael Aguirre] said the move confirms that the firm has the same problems with the depth of Vinson & Elkins' work product that KPMG, the city's outside auditor, expressed last fall.

"Vinson & Elkins' lack of independence was well-known to KPMG and to the audit committee before the audit committee signed on," Aguirre said.

Kroll was hired by the city in February to review internal investigations into city finances by Vinson & Elkins and the City Attorney's Office. The company will also provide consulting assistance regarding internal financial-control deficiencies at City Hall.

Full Text (598 words)

Copyright SAN DIEGO UNION TRIBUNE PUBLISHING COMPANY Apr 23, 2005

Editions vary

Consultants hired to review internal investigations into San Diego city finances want to bring more lawyers into the mix, reopening debate over the work of Vinson & Elkins, a Washington law firm paid nearly \$4 million to study City Hall's financial practices.

The debate over its work is also fueled by revelations that its latest investigation, into whether anyone at City Hall broke the law, may be presented to the city's audit committee orally and not in writing.

City Manager Lamont Ewell defended the pace of internal investigations into city finances, saying auditors are making progress. But he did not say when their work will be done.

City Attorney Michael Aguirre said the move to hire more lawyers, and the absence of a written report by Vinson & Elkins, means long- overdue audits of the city's books may be many months from completion.

"The city has wasted \$4 million on Vinson & Elkins, and now we learn that we're not going to ever see their written report addressing whether there were illegal acts or not," Aguirre said yesterday.

Vinson & Elkins lawyer Paul Maco declined to comment.

Ewell said hiring more outside lawyers is consistent with City Hall's contract with Kroll Inc., the consulting firm that has provided the city's three-member audit committee.

Ewell also said an oral report would be acceptable, according to what he was told by Lynn Turner, a Kroll senior adviser leading the audit team.

"From an auditing investigative report, you're looking at the work product, the methodology of getting there, how you test something," Ewell said. "So it's not so much a written report."

In a letter to Kroll on Thursday, Aguirre objected to hiring more outside lawyers, calling the move unnecessary and one which must be approved by the mayor and City Council.

Yesterday Aguirre said the move confirms that the firm has the same problems with the depth of Vinson &

Ex 10

Elkins' work product that KPMG, the city's outside auditor, expressed last fall.

Turner denied in an interview Thursday that there are significant problems with Vinson & Elkins.

KPMG has been working on -- but has not finished -- audits of the city's 2003 and 2004 books. The absence of these reports led one major Wall Street credit-rating agency, Standard & Poor's, to suspend its rating of the city in September.

A letter from KPMG in October that expressed concerns with Vinson & Elkins said the audits cannot be completed until the possibility of illegal acts by city officials is explored.

The previous month, Vinson & Elkins issued a voluminous report finding widespread irregularities in the city's financial reporting practices, but no evidence of wrongdoing.

Vinson & Elkins was hired last year to represent the city in talks with the Securities and Exchange Commission.

The SEC is investigating possible securities fraud related to the city's failure to disclose troubles at the \$3.6 billion San Diego City Employees Retirement System in documents provided to investors.

The FBI and U.S. Attorney's Office are also investigating the pension system, which has a \$1.4 billion deficit, and the city's financial practices.

In the wake of KPMG letters, the city directed Vinson & Elkins to look into possible illegal acts.

"Vinson & Elkins' lack of independence was well-known to KPMG and to the audit committee before the audit committee signed on," Aguirre said.

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Credit: STAFF WRITER

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Companies:

KPMG International (NAICS: 541211), Kroll Associates (Sic:7381), Vinson & Elkins

Section:

LOCAL

Text Word Count 598

Document URL:

EXHIBIT NO. 12

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78" Seemile Assume New York, NY 16913 6093 Yok 212 728 8686 Pub 212 728 9280

April 19, 2005

Audit Committee of the City of San Diego o/o Mr. Troy A. Dahlberg Kroll Inc. 660 South Figueroa Street - 9th Floor Los Angeles, CA 90017

Re: Terms of Engagement as Counsel to the Audit Committee of the City of San Diego

Members of the Audit Committee:

This letter confirms the terms of our engagement by the Audit Committee of the City of San Diego (the "Audit Committee").

The purpose of our engagement is to assist the Audit Committee in connection with financial reporting and other issues that have arisen concerning the San Diego City Employees' Retirement System ("SDCERS"). The scope of our engagement will include counsel and assistance to the Audit Committee in connection with its independent investigation into SDCERS finances and disclosure. It will also include other matters that, in the judgment of the Audit Committee, may require inquiry or investigation. In our capacity as counsel to the Audit Committee, we are being engaged by, and will report exclusively to, the Audit Committee. Accordingly, we will serve with complete independence from the Mayor of San Diego, the San Diego City Council, the City, and the City's departments, agencies, and elected city officials.

We will follow the convention of charging for services based on hourly rates (subject to revision on an annual basis on October 1) which, at present, range from \$560 to \$625 for partners, \$240 to \$555 for associates, and \$110 to \$200 for legal assistants and others. We will also follow the convention of associates, and \$110 to \$200 for legal assistants and others. We will also follow the convention of including with our bill a statement for disbursements, costs, and other charges incurred which normally include such things as duplicating, long distance telephone, computerized legal research, travel, and other such expenses. The Audit Committee will be entitled, in the event of a fee dispute involving amounts from \$1,000 to \$50,000, to seek arbitration in accordance with Pant 137 of the Rules of the Chief Administrator of the New York courts. We do not construct this engagement as creating an attorney-client relationship with any persons or entities other than the Audit Committee.

Although we are serving as counsel to the Audit Committee, payment of our bills is to be the responsibility of the City and, by signing and thereby acknowledging its payment obligations under this engagement letter, the City through a duly authorized representative agrees to fulfill that

NEW YORK WASHINGTON PAULS LONDON MILAN ROME FRANKFURT DRUSEBLE

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Audit Committee of the City of San Diego c/o Mr. Troy A. Duhlberg Kroll Inc. April 19, 2005 Page 2

responsibility. We will transmit bills monthly, or more frequently depending upon the level of activity, by sending them to P. Lamout Ewell, City Manager. A copy will be transmitted to the Audit Committee as well. Payment will be due no later than 15 days after the date upon which a bill is transmitted. We shall require the full payment of any indebtedness prior to the issuance of any report and we may stop work at any time in the event of a payment delinquency. We may also resign this engagement for any reason in our sole discretion within five business days after prior written notice.

Should any effort be made (a) either by subpoens, discovery demand or otherwise to gain access to information, materials, documents, work product or information of any kind in the possession of Wilkie Fan & Gallagher LLP ("WF&G") that has been generated, obtained or learned as a result of the work performed by WF&G under the engagement, or (b) to otherwise prevent, interrupt or interfere with the performance of WF&G's work in connection with the engagement, whether by judicial action with the performance of WF&G's work in connection with the engagement, whether by judicial action or other means, then in such event, subject to the other provisions of this letter, to the extent feasible and permissible by law we shall promptly multip you and follow lawful directions from you with respect to our response to any such effort. The City agrees to pay, reimburse, indemnify and hold barmless WF&G for all costs and expenses (including time charges, fees, disbursements, and reasonable attorney fees) that may be incurred or generated by the firm in connection with, or that may arise out of or relate to, any effort undertaken in response to any such effort or judicial action of pursuant to any direction from you.

The City agrees to indemnify and bold harmless WF&G for any claims or judgments against WF&G attains out of this engagement, including monthly reimbursement for all WF&G time charges, fees, costs, attorney fees and disbursements and defense or other costs, unless and until it were to be finally adjudicated that WF&G's actions were negligent, tortious or beyond the scope of the engagement.

We are prepared to commence work immediately upon receipt of a \$250,000 retainer which we will hold until the conclusion of the engagement and thereupon either return to the City or apply to the final involoc(s).

We look forward to being of service to the Audit Committee.

Very truly yours,

Michael R. Young

FROM :

FAX NO.:

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May 05 05 09:18a City of San Diego

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Audit Committee of the City of San Diego o/o Mr. Troy A. Dahlberg Kroll Inc. April 19, 2005 Page 3

AGREED:

For the Audit Committee of the City of San Diego

ACKNOWLEDGED:

P. Lamont Ewell, City Manager For the City of San Diego

EXHIBIT NO. 13

WILLKIE FARR & GALLAGHER UP



Benito Romano

Partner bromano@willkie.com

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Benito Romano is a partner in the Litigation Department of Willkie Farr & Gallagher LLP in New York. Mr. Romano specializes in complex criminal and civil litigation in all phases leading to trial, including criminal and regulatory investigations.

Selected Professional and Business Activities

Mr. Romano is a member of the American Bar Association, Section on White Collar Crime Practice; the New York State Bar Association, Section on Trial Practice; the Federal Bar Council; and the Association of the Bar of the City of New York, Chair, Litigation Committee. He serves as a member of the Magistrate Selection Panel for the Southern District of New York.

Over the last decade, Mr. Romano has been a lecturer or participant in panel discussions before practicing attorneys on numerous topics related to federal criminal law.

Prior Experience

Prior to his return to private practice, Mr. Romano served as United States Attorney, representing the United States in all criminal and civil court proceedings in the Southern District of New York. He supervised approximately 160 Assistant United States Attorneys in the Criminal and Civil Divisions of his office. Prior to assuming the position of United States Attorney, Mr. Romano served in a variety of supervisory and executive positions in that office.

Education

1977, Columbia University School of Law, J.D. 1972, New York University, B.A.

Bar Admissions

New York, 1977

Courts

- United States Court of Appeals, 2nd Circuit, 1984
- United States Court of Appeals, 6th Circuit, 1991
- United States District Court, Eastern District of New York, 1994
- United States District Court, Southern District of New York, 1977

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LOCAL

Pension investigators criticized anew | Firm is seeking more legal help

Philip J. LaVelle

STAFF WRITER

632 words

23 April 2005

The San Diego Union-Tribune

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English

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Michael R. Young is a litigation partner specializing in securities and financial reporting with a particular emphasis in accounting irregularities.

His practice focuses upon the representation of officers, directors, audit committees, accounting firms, outside professionals, and companies in securities class actions, SEC proceedings, and special investigations. His trial work has included financial reporting matters in federal, state, and bankruptcy courts throughout the United States, including the first class action tried to a jury pursuant to the Private Securities Litigation Reform Act of 1995. His appellate work has included matters at all levels of state and federal courts.

Mr. Young is a member of the Financial Accounting Standards Advisory Council to the Financial Accounting Standards Board and also serves as counsel to the American Institute of Certified Public Accountants. He has been ranked by *Chambers (USA)* among the leading attorneys practicing securities litigation and has been named by *Accounting Today* as one of the "top 100 most influential people in accounting." He is also a member of the New York Mayor's Advisory Committee on the Judiciary.

Selected Professional and Business Activities

A frequent author on the subjects of financial reporting, audit committee effectiveness and the role and responsibilities of the independent auditor, Mr. Young's publications include *The Financial Reporting Handbook* (Aspen 2003) and *Accounting Irregularities and Financial Fraud* (Aspen 2d ed. 2002). He has also submitted testimony in hearings before the Senate Banking Committee's Subcommittee on Securities, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees of the New York Stock Exchange and the National Association of Securities Dealers, and the Panel on Audit Effectiveness of the Public Oversight Board.

Selected Significant Matters Congressional and Regulatory Testimony

- Hearing on Adapting a 1930's Financial Reporting Model to the 21st Century, before the Subcommittee on Securities of the Senate Banking Committee (convened by Senate subcommittee to explore potential innovations in financial reporting to address concerns regarding accounting irregularities, earnings management, and stock market volatility)
- Hearings before the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit
 Committees of the New York Stock Exchange and the National Association of Securities Dealers (written
 testimony provided to blue ribbon panel at the request of the SEC)
- Hearings before the Panel on Audit Effectiveness of the Public Oversight Board (panel created at the request of the SEC to study potential improvements to the outside audit function)

Legislative and Regulatory Pronouncements

Assisted in preparation and/or enactment of:

• Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78j-1 (Supp. 1996) (federal securities reform

Ex 13-13

legislation passed by Congress over veto of President Clinton in December 1995)

- Securities Litigation Uniform Standards Act of 1998, S. 1260, 105th Cong., 2d Sess. (federal securities reform legislation enacted to further implement objectives of Private Securities Litigation Reform Act)
- Uniform Accountancy Act, see Accountancy Law Reporter 1031-1050 (CCH) (uniform act governing certification and practice of CPAs, presently enacted in whole or in part in most states)
- Statement on Auditing Standards No. 53, <u>The Auditor's Responsibility to Detect and Report Errors and Irregularities</u>
- Statement on Auditing Standards No. 54, Illegal Acts by Clients
- Statement on Auditing Standards No. 55, Consideration of Internal Control in a Financial Statement Audit
- Statement on Auditing Standards No. 57, <u>Auditing Accounting Estimates</u>
- Statement on Auditing Standards No. 58, Reports on Audited Financial Statements
- Statement on Auditing Standards No. 59, <u>The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern</u>
- Statement on Auditing Standards No. 60, <u>Communication of Internal Control Related Matters Noted in an Audit</u>
- Statement on Auditing Standards No. 61, Communication With Audit Committees
- Statement on Auditing Standards No. 65, <u>The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements</u>
- Statement on Auditing Standards No. 69, <u>The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report</u>
- Statement on Auditing Standards No. 82, <u>Consideration of Fraud in a Financial Statement Audit</u>; <u>see AICPA Professional Standards</u> AU §§ 316-623 (professional standards constituting Generally Accepted Auditing Standards)
- <u>Internal Control -- Integrated Framework</u> (prepared by the Committee of Sponsoring Organizations pursuant to recommendations of the National Commission on Fraudulent Financial Reporting)
- An Act Relating to the Sale of Certificates of Deposit, 31 Iowa Code §§ 534.702, 534.704 (1993)
 (amendment to Iowa banking code exempting certain broker-dealer activities in connection with brokered CDs)
- An Act Concerning Accountants' Liability, N.J. Stat. C.2A:53A-25 (amendment to New Jersey state code limiting non-privity actions against accountants)

Accounting Investigations

Participated in investigations or inquiries into potential accounting issues involving:

HealthSouth Corporation; Enron Corporation; Xerox Corporation; Cendant Corporation; Edison Schools
Inc.; Just for Feet, Inc.; Lancer Corporation; Janus Funds; Metromedia Fiber Network, Inc.; Elan
Corporation; Footstar, Inc.; Anicom, Inc.; Gemstar-TV Guide International, Inc.; Med Diversified, Inc.;
Emex Corporation; Gerber Scientific, Inc.; Interpool, Inc.; Lucent Technologies Inc.; Health Management,
Inc.; Twinlab Corporation; Cumulus Media, Inc.; Worldwide Xceed Group, Inc.; Breed Technologies, Inc.;
Information Management Associates, Inc.; and Sharp International Corporation.

Litigations

- In re The Leslie Fay Companies, Inc. Securities Litigation, No. 92 Civ. 8036 (S.D.N.Y.) -- Representing defendant accounting firm in \$76 million securities class actions arising out of accounting irregularities at Leslie Fay. See In re The Leslie Fay Cos. Sec. Litig., 918 F. Supp. 749 (S.D.N.Y. 1996); Wall Street Journal, Mar. 28, 1995, at 1, B1; Wall Street Journal, Mar. 29, 1995, at B10; Wall Street Journal, Apr. 7, 1995, at B4; American Lawyer, June 1995, at 101; New York Law Journal, May 2, 1996, at 3
- In re Health Management, Inc. Securities Litigation, No. 96-CV-889 (E.D.N.Y.) -- Representing defendant accounting firm in four-week jury trial of securities class actions arising out of discovery of accounting irregularities at Health Management, Inc. See In re Health Management, Inc. Securities Litigation, 184 F.R.D. 40 (E.D.N.Y. 1999); Wall Street Journal, Feb. 28, 1996, at B6; Wall Street Journal, Oct. 28, 1999, at B2; National Law Journal, Nov. 15, 1999, at B5; New York Law Journal, Oct. 29, 1999, at 1; Accounting Today, Nov. 22, 1999, at 3; Journal of Accountancy, Feb. 2000, at 15
- In re Fine Host Corp. Securities Litigation, No. 3-97CV02619-JCH (D. Conn.) -- Representing defendant company in \$175 million securities class actions and bondholder actions arising out of discovery of accounting irregularities and subsequent restatement of earnings. See Wall Street Journal, Dec. 15, 1997, at A8; New York Times, Dec. 16, 1997, at D12; Wall Street Journal, Feb. 9, 1998, at 1, C17; Forbes, March 23, 1998, at 124
- In re Candie's, Inc. Securities Litigation, No. 99 Civ. 3618 (S.D.N.Y.) -- Representing defendant company, officers, and directors in securities class actions arising out of discovery of alleged accounting irregularities at Candie's, Inc. See Wall Street Journal, June 16, 1999, at B13; Wall Street Journal, June 28, 1999, at A8; Wall Street Journal, Sept. 23, 1999, at B19; New York Post, Sept. 23, 1999, at 38
- In re Twinlab Corp. Securities Litigation, No. 98-CV-7425 (E.D.N.Y.) -- Representing defendant company in securities class actions arising out of discovery of alleged accounting irregularities followed by decline in stock value of \$80 million. See New York Observer, Feb. 15, 1999, at 1; Wall Street Journal, Feb. 25, 1999, at B9; Newsday, Feb. 25, 1999, at A52; Newsday, Mar. 29, 1999, at C8; Wall Street Journal, Feb. 14, 2000, at A34
- In re Alert Securities Litigation, No. 92-Z-9150 (D. Colo.) -- Representing defendant telecommunications company in \$250 million multi-district securities class actions. See New York Times, Jan. 12, 1992, at 3-15; Los Angeles Times, Mar. 3, 1992, at D1
- In re Mid-American Waste Systems, Inc. Securities Litigation, No. 97-325-AJL (D. N.J.) -- Representing defendant officers and directors in multi-district securities actions arising out of alleged fraud in connection with \$175 million junk-bond offering. See Wall Street Journal, Apr. 16, 1996, at B14
- In re Physician Computer Network, Inc. Securities Litigation, No. 98-981-MTB (D. N.J.) -- Representing director and consultant in investigation and multi-district securities class actions arising out of discovery of accounting irregularities at Physician Computer Network, Inc. See Wall Street Journal, Mar. 4, 1998, at B5, C7; Wall Street Journal, Apr. 3, 1998, at B5
- <u>In re Safety Components International, Inc. Securities Litigation</u>, No. 2000-82-AJL (D. N.J.) -- Representing defendant company and officers and directors in securities class actions arising out of alleged accounting irregularities and restatement of earnings
- <u>Schwartz v. Dialogic Corp.</u>, No. MRS-L-2432-96 (Super. Ct. N.J.) -- Representing defendant company and officers and directors in \$81 million securities class action alleging fraud based on disappointing earnings
- <u>In re Union Square Associates Securities Litigation</u>, No. 11028 (Del. Ch.) -- Representing defendant issuer, investment bank, officers, and directors in \$72 million multi-district securities class actions
- In re First American Center Securities Litigation, No. MDL 869 (S.D.N.Y.) -- Representing defendant issuer, investment bank, officers, and directors in \$17 million multi-district securities class actions

- Securities Investor Protection Corp. v. BDO Seidman, LLP (S.D.N.Y.) -- Representing defendant
 accounting firm in \$77 million financial reporting litigation arising out of accounting irregularities and
 criminal misconduct at A.R. Baron & Co., Inc. See Wall Street Journal, Mar. 31, 1998, at B13; New York
 Times, Mar. 31, 1998, at D7; New York Law Journal, June 12, 2000, at 4; New York Law Journal, June 28,
 2000, at 4
- Sullivan v. Shearson California Radisson Plaza Partners L.P., No. 89-5472 (C.D. Cal.) -- Representing defendant issuer, investment bank, officers, and directors in \$70 million securities class actions
- In re Colonial Realty Co., Nos. CV-92-0518561-S to CV-92-0518572-S (Super. Ct. Conn.) -- Representing defendant AICPA in \$350 million securities class actions arising out of accounting irregularities at network of real estate development companies. See Waters v. Autuori, 236 Conn. 820, 676 A.2d 357 (S. Ct. 1996); Journal of Accountancy, Nov. 1996, at 94; D. Causey & S. Causey, Duties and Liabilities of Public Accountants (5th ed. 1995) (Jan. 1998 Supp. at 7); 76 The CPA Letter, at 5 (Sept. 1996); see generally The Hartford Courant, Nov. 11, 1996, at A1
- Robbins v. Koger Properties, Inc., No. 95-2882 (11th Cir.) -- Representing AICPA as amicus curiae participant before Eleventh Circuit in appeal seeking to overturn \$81.3 million jury verdict in securities class action against accounting firm. See Robbins v. Koger Properties, Inc., 116 F.3d 1441 (11th Cir. 1997); Wall Street Journal, Mar. 8, 1995, at B8; New York Times, Mar. 8, 1995, at D2; National Law Journal, Sept. 8, 1997, at B1
- In re Bennett Companies Investors Litigation, No. 96-601927 (N.Y.S. Ct.) -- Representing defendant broker in \$570 million securities class action arising out of alleged accounting irregularities and Ponzi scheme at Bennett Funding. See New York Times, Mar. 30, 1996, at 1-41; Wall Street Journal, Apr. 17, 1996, at 1; Washington Post, Aug. 10, 1996, at A1
- Rabin v. Concord Assets Management Group, Inc., No. 89 Civ. 6130 (S.D.N.Y.) -- Representing defendant
 accounting firm in \$700 million securities class action
- The Hartz Mountain Corp. v. BDO Seidman, LLP, No. 96 Civ. 3042 (S.D.N.Y.) -- Representing defendant accounting firm in \$15 million securities action arising out of tender offer for nonpublic company
- TBK Partners v. ICH Corp., No. C-82-0695 (W.D. Ky.) -- Representing investment bank in securities class actions involving allegedly improper fairness opinion
- <u>Trump v. The Griffin Co.</u>, No. 88 Civ. 1870 (S.D.N.Y.) -- Representing plaintiff real estate developer in securities action in connection with acquisition of the Taj Mahal casino in Atlantic City. <u>See Wall Street Journal</u>, Mar. 22, 1988, at 4; <u>New York Times</u>, May 12, 1988, at D1; <u>Business Week</u>, May 16, 1988, at 101
- In the Matter of Fred Alger Management, Inc., No. NY-5696 (SEC) -- Representing registered investment adviser in SEC investigation arising out of mutual fund advertisements
- Efffroncy KPMG Peat Marwick, No. 11107/91 (N.Y.S. Ct.) -- Representing defendant accounting firm in four-week jury trial arising out of action to recover damages allegedly caused by improper audit of financial statements. See New York Law Journal, Apr. 20, 1994, at 21; New York Law Journal, June 2, 1994, at 5
- RTC v. Castellett, No. 92-4635 (D. N.J.) -- Representing defendant accounting firm in \$62 million action prosecuted by RTC arising out of failed savings and loan association
- FDIC v. Main Hurdman, No. S-85-552 (E.D. Cal.) -- Representing defendant accounting firm in \$166 million, ten-month jury trial prosecuted by FDIC arising out of failure of Continental Illinois National Bank and Trust Company. See FDIC v. Main Hurdman, 655 F. Supp. 259 (E.D. Cal. 1987); Failed Bank & Thrift Lit. Rptr., Nov. 27, 1991, at 14420; Failed Bank & Thrift Lit. Rptr., Mar. 11, 1992, at 14918; D. Causey & S. Causey, Duties and Liabilities of Public Accountants, at 12 (5th ed. 1995); J. Whitney, The Trust Factor: Liberating Profits & Restoring Corporate Vitality, at xvi (1994)

- Gee v. Seidman & Seidman, No. 82,365 (Fla. S. Ct.) -- Representing AICPA as <u>amicus curiae</u> participant before Florida Supreme Court in appeal seeking reinstatement of jury verdict in action against accounting firm. <u>See Seidman & Seidman v. Gee</u>, 625 So. 2d 1 (Fla. App. 1992); D. Causey & S. Causey, <u>Duties and Liabilities of Public Accountants</u>, at 143, 200, 388, 392 (5th ed. 1995); <u>Accountant's Liability Review</u>, at 1 (May 1994); <u>see also Wall Street Journal</u>, Apr. 17, 1992, at B8
- Ibanez v. Florida Department of Business and Professional Regulation, Board of Accountancy, No. 93-639
 (U.S.) -- Representing AICPA as <u>amicus curiae</u> participant before United States Supreme Court in First
 Amendment challenge to state accountancy regulations. <u>See Ibanez v. State of Florida Dep't of Business & Prof. Reg.</u>, 114 S. Ct. 2084 (1994); <u>Wall Street Journal</u>, June 14, 1994, at B10; <u>National Law Journal</u>,
 June 27, 1994, at A12
- <u>United States v. Tenzer</u>, No. 96-1653 (2d Cir.) -- Representing AICPA as <u>amicus curiae</u> participant before Second Circuit in appeal arising out of Internal Revenue Service action against a practicing CPA
- <u>Kemin Industries, Inc. v. KPMG Peat Marwick</u>, No. 96-1093 (S. Ct. IA) -- Representing AICPA as <u>amicus curiae</u> participant before Iowa Supreme Court in appeal seeking to overturn jury verdict in action against accounting firm
- <u>> Colorado State Board of Accountancy v. Zaveral Boosalis Raisch</u>, No. 96-SC-579 (S. Ct. Colo.) Representing AICPA as <u>amicus curiae</u> participant before Colorado Supreme Court in appeal arising out of state board of accountancy proceeding against accounting firm
- In re WRT Energy Securities Litigation, No. 96-3610-JFK (S.D.N.Y.) -- Representing accounting firm to
 establish precedent governing confidentiality protections applicable to accounting firms producing audit
 work papers as nonparties to litigation
- Scioto Memorial Hospital Ass'n v. Price Waterhouse & Co., No. 94-409 (Ohio S. Ct.) -- Representing AICPA as <u>amicus curiae</u> participant before Ohio Supreme Court in appeal seeking to overturn jury verdict in action against accounting firm. <u>See Scioto Memorial Hospital Ass'n v. Price Waterhouse</u>, 659 N.E. 2d 1268 (Ohio S. Ct. 1996)
- State of Iowa v. Shearson/American Express Co., No. 81-514-A (S.D. Iowa) -- Representing defendant investment bank in action to enjoin brokerage firm involvement with certificates of deposit. See Iowa v. Shearson/American Express Co., 408 N.W.2d 363 (Iowa 1987); see also M. Mayer, The Greatest Ever Bank Robbery, at 23 (1990)
- Holt Leasing Co. v. Main Hurdman, No. 185006 (Cal. Super. Ct.) -- Representing defendant accounting firm in action to recover damages allegedly caused by improper advice as to financial restructuring
- <u>National Medical Transportation Network v. Deloitte & Touche</u>, No. D024940 (Cal. 4th App. Dist.) -- Representing AICPA as <u>amicus curiae</u> participant before California Court of Appeal in appeal seeking to overturn jury verdict in action against accounting firm

Selected Publications and Lectures

- The Financial Reporting Handbook (Aspen 2003)
- Accounting Irregularities and Financial Fraud (Aspen 2d ed. 2002)
- Accountant Liability in Litigation Services Handbook: The Role of the Financial Expert (Wiley 2001) (contributing author)
- <u>Eighteen Safeguards to Corporate Self-Investigation</u>, 12 Metropolitan Corporate Counsel 13 (December 2004)
- The Liability of Corporate Officials to their Outside Auditor for Financial Statement Fraud, 64 Fordham L.
 Rev. 2155 (1996), reprinted in The Best in D&O Duties and Liabilities (Bowne 1997) and Corporate

Compliance: How to Be a Good Citizen Corporation Through Self-Policing (PLI Supp. 1996)

- <u>Financial Reporting and Risk Management in the 21st Century</u>, 65 Fordham L. Rev. 1987 (1997) (coauthored with AICPA's General Counsel to present legal precepts underlying risk-management proposals of AICPA's Special Committee on Assurance Services)
- A Shift in Responsibility for Financial Reporting: The Trend of a Decade (commissioned by AICPA Center for Excellence in Financial Management for presentation at 1998 AICPA Fall National Industry Conference)
- The Origin of Financial Fraud, 8 Metropolitan Corporate Counsel 14 (April 2000)
- The Audit Committee, Internal Audit, and the Outside Auditor, 8 Metropolitan Corporate Counsel 15 (May 2000)
- Managing an Accounting Disaster, Securities Litigation 2000 (PLI 2000)
- <u>Financial Reporting and the Accounting Profession: The Whirlwind Continues</u>, 31st Annual Institute on Securities Regulation, 1151 PLI/Corp 95 (1999) (commissioned by ABA Section of Business Law for 1999 Annual Meeting)
- The Origin of Financial Fraud: So Who Gets the Blame?, 8 Metropolitan Corporate Counsel 14 (June 2000)
- Materiality and Misstatements in Financials: A New SEC Attack Against "Earnings Management," 7 Panel Counsel Forum 1 (2000)
- What Is An Audit Committee To Do?, N.Y.L.J., Dec. 16, 1999, at 1
- When Investors Rely on Financial Projections, 177 J. of Acct. 26 (1994)
- The Future of Financial Reporting, 4 Panel Counsel Forum 6 (1997).
- <u>Materiality Assessments and Misstatements in Financial Statements</u>, 7 Metropolitan Corporate Counsel 11 (Nov. 1999)
- SEC Adopts Audit Committee Rules Based on Blue Ribbon Panel's Recommendations, 8 Metropolitan Corporate Counsel 5 (Feb. 2000)
- Chair, "Financial Reporting and the Accounting Profession" (panel sponsored by Law and Accounting Committee of the American Bar Association at 1999 Annual Meeting)
- Chair, "Accounting Irregularities: The Peril, Discovery & Cure" (half-day conference on accounting
 irregularities co-sponsored by the Financial Executives Institute, American International Group, Inc. and
 Willkie Farr & Gallagher)
- Speaker, "Today's CFO -- Financial Reporting Responsibilities and Liability" (lecture on trends in responsibility and liability for financial reporting commissioned by AICPA Center for Excellence in Financial Management)
- "The Origin of Financial Fraud and the Investigative Process" (sponsored by the Foundation for Accounting Education)
- "Accounting Irregularities & Financial Fraud: What's An Audit Committee To Do?" (sponsored by Nasdaq, the American Stock Exchange, and AIG)
- "The Internal Crisis: Managing an Accounting Disaster" (commissioned by the Information Technology Association of America, Patton Boggs LLP, and AIG)
- "Accounting Irregularities and the Evolution of Financial Reporting" (before the CFO Roundtable in Atlanta)

- "Internal Audit and the Blue Ribbon Committee on the Effectiveness of Corporate Audit Committees" (before the Institute of Internal Auditors at the Year 2000 International Conference in New York)
- "The Auditor and Financial Fraud" (commissioned by Big 5 accounting firm for national industry conferences in Miami and Las Vegas)
- "Accounting Irregularities and Internal Audit" (commissioned by The Institute for Internal Auditors and the Association of Certified Fraud Examiners for their 1999 Fraud Conference)
- "Accounting Fraud: Is Everyone Doing It?" (panel discussion sponsored by National Economic Research Associates)
- "The SEC's Materiality Standard and the Applicability of New SAB 99" (panel discussion with the present and former SEC Directors of Enforcement)
- "SEC Accounting Initiatives: How They Affect Your Practice", (panel discussion with the SEC's General Counsel and former Director of Division of Corporate Finance sponsored by Section of Business Law of the American Bar Association)
- "The Origin & Detection of Accounting Irregularities" (to audience of securities analysts on fraudulent financial reporting)
- "Financial Fraud: Origin & Aftermath" (industry conference of D&O insurance brokers)
- "Credit Union Deposits: Are They Debt or Equity" (before Credit Union Committee of American Bar Association)
- "Section 10A Reports and New Issues as to 'Illegal Acts' under the 1934 Act" (lecture presented to corporate counsel based upon new reporting requirements in the Private Securities Litigation Reform Act of 1995)
- "Accounting Irregularities and the D&O Insurer" (seminar for claims and underwriting departments of D&O insurer on practical and legal issues arising out of the discovery of accounting irregularities at the companies of insured D&Os)
- "Accountants' Liability as to Corporate Practice: A Changing Legal Environment" (before the School of Professional Accountancy of Long Island University)
- "The Hazards of Severing a Client Relationship" (before New York State Society of CPAs)
- "A Conceptual Approach to Financial Statements and Financial Analysis" (continuing legal education lecture presented to bankruptcy and trail lawyers)

Additional Information

- American Bar Association (Section of Litigation; Section of Business Law; Committee on Law and Accounting; Ad Hoc Committee on Public Company Information Practices)
- Association of the Bar of the City of New York (Committee on Legal Education and Admission to the Bar, 1982-87)
- Counsel to the American Institute of Certified Public Accountants (1987-present)
- Member, Securities and Shareholder Litigation Practice Panel, American International Group, Inc.

Education

1981, Duke University School of Law, J.D. 1978, Allegheny College, B.A.

Bar Admissions

New York, 1982

Courts

- United States Supreme Court, 1994
- United States Court of Appeals, 2nd Circuit, 1996
- United States Court of Appeals, 9th Circuit, 1990
- United States Court of Appeals, 11th Circuit, 1995
- united States District Court, Eastern District of New York, 1982
- United States District Court, Southern District of New York, 1982



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| Sort By: Last Name | | | | |
|--------------------------|----------|--------|---------------|--------------|
| Name | Status | Number | City | Admission Da |
| Romano, Albert John | Active | 194001 | San Francisco | January 1998 |
| Romano, Anthony Joseph | Active | 121021 | San Diego | December 198 |
| Romano, Bruce Alan | Inactive | 73659 | Washington | December 197 |
| Romano, Daniel | Active | 117704 | Los Angeles | June 1985 |
| Romano, Frank Joseph | Active | 152471 | 75116 Paris | June 1991 |
| Romano, Jennifer Salzman | Active | 195953 | Los Angeles | May 1998 |
| Romano, Joseph Fredrick | Active | 179048 | Denver | December 199 |
| Romano, Karen Feldman | Inactive | 156440 | Los Angeles | December 199 |
| Romano, Kevin Bobbett | Active | 117052 | San Jose | December 198 |
| Romano, Laura Dinorcia | Active | 127832 | San Diego | June 1987 |
| Romano, Lynne Margery | Active | 123413 | Palm Desert | June 1986 |
| Romano, Malcolm Joseph | Active | 73458 | Los Angeles | December 197 |
| Romano, Mark Allan | Active | 171483 | San Diego | June 1994 |
| Romano, Michael Joseph | Inactive | 87653 | Fairfield | November 197 |
| Romano, Michael Stone | Active | 232182 | San Francisco | October 2004 |
| Romano, P Jacqueline | Active | 162696 | Los Angeles | December 19 |
| Romano, Richard Leroy | Active | 39359 | San Francisco | December 196 |
| Romano, Robert Kevin | Active | 86712 | Van Nuys | May 1979 |
| Romano, Sara Jean | Active | 227467 | San Francisco | December 20(|
| Romanoff, Steven Michael | Active | 131818 | La Jolla | December 198 |
| Romanowsky, Mindie S | Active | 195525 | Menlo Park | June 1998 |
| | | | | |

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| Sort By: Last Name | \S | | | |
|--------------------------|------------------------------|--------|-------------|----------|
| Name | Status | Number | City | Admissio |
| Young, Michael R. | Active | 39491 | Bakersfield | December |
| Young, Michael Robert | Active | 205031 | Redlands | December |
| Younger, Michael Richard | Not Eligible To Practice Law | 96692 | Glendale | December |

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ATTORNEY SEARCH

Michael R. Young - #39491

Current Status: Active

This member is active and may practice law in California.

See below for more details.

Profile Information

| Bar Number | 39491 | | |
|------------|---|-------------------------|---|
| Address | Young & Nichols | Phone Number | (661)861-7911 |
| | 1901 Truxtun Ave Bakersfield, CA 93301 | Fax Number | (661)861-7932 |
| | | e-mail | Not Available |
| | | | |
| District | District 5 | Undergraduate School | Univ of California a Angeles; CA USA |
| County | Kern | Law School | UC Hastings COL; |

Status History

| Effective Date | Status Change | |
|----------------|---|--|
| Present | Active | |
| 12/23/1966 | Admitted to The State Bar of California | |

Explanation of member status

Actions Affecting Eligibility to Practice Law

Effective Date Description

Case Number Resulting

Disciplinary

This member has no public record of discipline.

Administrative

12/18/1969

Suspended, failed to pay Bar membr. fees

Public Protection

This member has no record of public protection actions.



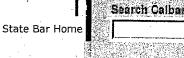
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ATTORNEY SEARCH

Michael Robert Young - #205031

Current Status: Active

This member is active and may practice law in California.

See below for more details.

Profile Information

| 205031 | | |
|----------------------|---|---|
| Elliot Snyder & Reid | Phone Number | (909)792-8861 |
| | Fax Number | (909)798-6997 |
| | e-mail | michael.young@es |
| | | |
| District 6 | Undergraduate School | California St Univ; : Bernardino CA US/ |
| San Bernardino | Law School | Southwestern Univ Los Angeles CA US |
| | Elliot Snyder & Reid 101 E Redlands Blvd #285 Redlands, CA 92373-4709 District 6 | Elliot Snyder & Reid 101 E Redlands Blvd #285 Redlands, CA 92373-4709 Phone Number Fax Number e-mail District 6 Undergraduate School |

Status History

| Effective Date | Status Change | | |
|----------------|--------------------------|-----------------|-------------|
| Present | Active | | |
| 12/7/1999 | Active | 1. j. j. j. j. | |
| 12/7/1999 | Admitted to The State Ba | r of California | |

Explanation of member status

Actions Affecting Eligibility to Practice Law

Disciplinary

This member has no public record of discipline.

Administrative

This member has no public record of administrative actions.

Public Protection

This member has no record of public protection actions.



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ATTORNEY SEARCH

Michael Richard Younger - #96692

Current Status: Not eligible to practice law (Not Entitled)

See below for more details.

Profile Information

| Bar Number | 96692 | | |
|------------|---|-------------------------|---|
| Address | Suite 900 | Phone Number | (818)242-6859 |
| | 100 West Broadway Glendale, CA 91210 | Fax Number | Not Available |
| | 3.6.12.16 | e-mail | Not Available |
| | | | |
| District | District 7 | Undergraduate School | Univ of California a Angeles; CA USA |
| County | Los Angeles | Law School | UC Hastings COL; Francisco CA USA |

Status History

| Effective Date | Status Change | | | |
|----------------|---|--|------|--|
| Present | Not Eligible To Practice Law | | | |
| 8/10/1992 | Not Eligible To Practice Law | | | |
| 4/4/1991 | Active | | • | |
| 7/30/1990 | Not Eligible To Practice Law | | | |
| 12/23/1980 | Admitted to The State Bar of California | | | |

Explanation of member status

Actions Affecting Eligibility to Practice Law

| Effective Date | Description | Case Number | Resulting Status |
|---------------------------------|--|----------------|---------------------------|
| Disciplina This membe | ry r has no public record of discipline. | | |
| Administr | ative | | |
| 8/10/1992 | Suspended, failed to pay Bar membr. fees | | Not Eligible To Pr Law |

EXHIBIT NO. 14

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Further Questions of City's Law Firm Could Continue Delay of Audits,

Investigations

By ANDREW DONOHUE Voice Political Writer Published April 22, 2005

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The city of San Diego's long struggle to finish a self-investigation and release its fiscal year 2003 and 2004 audits appears headed toward a new phase -- one with more outside legal counsel.

The consultants brought in to usher the city out of its financial and political storm have alerted city officials they will likely ask to bring in their own legal counsel because of concerns over the independence of the city's chosen law firm, said Troy Dahlberg. He is one of three accountants -- the other two are former high-ranking officials at the Securities and Exchange Commission - tasked with untangling the city's cluster of investigations, accusations and audits.

The switch could mean further delays in the attempt to close the investigations and return the city to the financial markets.

Officials from auditor KPMG and the investigators from the SEC have voiced concerns over the independence of the firm currently conducting the city's investigation into possible criminal acts in connection with the city's \$1.37 billion pension deficit. Critics and experts have questioned whether the firm, Vinson & Elkins, which is also representing the city before the SEC, can be independent enough to conduct a sufficient investigation.

"Normally your attorney is your advocate for the city. It's hard to say you're an advocate and be independent at the same time," Dahlberg said.

The firm released a self-investigation in September that city officials hoped would reconcile the SEC's concerns over errors and omissions found in financial statements given to potential investors. The errors failed to fully account for the city's pension debt, among other things.

While that investigation was being conducted for the SEC, auditor KPMG became involved and warned city officials in a series of letters in the summer and fall that the investigation by the law firm likely wouldn't be sufficient to satisfy their worries that wrongdoing had been committed by city officials. Already on the hook for the V&E report, officials pushed ahead with the hope it would suffice for KPMG as well.

It turns out the report didn't satisfy anyone.

Neither Mayor Dick Murphy nor City Manager Lamont Ewell returned calls for comment. In a previous interview, Ewell said the city was aware of concerns from the start about the firm's independence, but stuck with them because of their experience.

The firm has been paid more than \$4 million since being hired in early 2004. It is one of a slew of outside consultants and firms brought in to assist the city. Dahlberg and his colleagues are paid between \$750 and \$900 per hour.

Dahlberg said his audit committee, which consists of former SEC chairman Arthur Levitt, will likely need independent counsel that has no connection to the city in order to analyze laws governing political wrongdoing and financial disclosures. The only

connection they will have to the city, he said, is through billing.

"I think there's enough attorneys," Councilwoman Donna Frye said.

The municipal world has been watching and waiting for the completion of V&E's investigation since October as a sign of the city's recuperation.

Lynn Turner, former chief accountant at the SEC and Dahlberg's colleague, said V&E will turn over its work to his committee. The committee will then combine it with work done by City Attorney Mike Aguirre in his three investigations. All the data and documents will be combined and turned in to KPMG and the SEC. It is unclear what V&E's role will be after turning over the work.

Turner and Dahlberg said the auditor and investigators will be comfortable with their level of independence. They are in the process of scheduling meetings with new pension board members to convince them of the importance of turning over documents sought by investigators.

"Once federal officials come in and look at questionable conduct, you are more than willing to do anything to cooperate with them, and I don't think anybody has explained that to them," Dahlberg said.

The board voted last week to maintain its attorney-client privilege in communications between former board members and attorneys. Federal investigators at the SEC and the U.S. Attorney's Office — which is investigating criminal wrongdoing — are seeking documents related to a controversial deal made between the city and pension board in 2002. The deal allowed the city to continue its historic underfunding of the pension system in exchange for increased benefits for employee unions.

The refusal to turn over the documents is another factor in the delays.

Please contact Andrew Donohue directly at with your thoughts, ideas, personal stories or tips.

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EXHIBIT NO. 17

CITY COUNCIL OF THE CITY OF SAN DIEGO SUPPLEMENTAL DOCKET NUMBER 4 FOR THE REGULAR MEETING OF TUESDAY, MAY 10, 2005 AT 10:00 A.M. CITY ADMINISTRATION BUILDING COUNCIL CHAMBERS – 12TH FLOOR 202 "C" STREET SAN DIEGO, CA 92101

ADOPTION AGENDA, DISCUSSION, OTHER LEGISLATIVE ITEMS

RESOLUTIONS:

ITEM-S504: Acceptance of Audit Committee's Status Report; First Amendment to Agreement with Kroll, Inc. for Services Related to the Audit of the City's Comprehensive Annual Financial Report (CAFR); and New Agreement with Willkie, Farr & Gallagher to Provide Independent Legal Counsel to Kroll and the Audit Committee On These Matters.

CITY MANAGER'S RECOMMENDATION:

Adopt the following resolutions:

Subitem-A:

In the matter of accepting the Audit Committee's Status Report.

Subitem-B: (R-2005-)

Authorizing a first amendment to the agreement with Kroll Inc. in the amount of \$1,500,000 for continued provision of investigative services in their role as the City's Audit Committee, and consulting assistance in assessing internal control deficiencies affecting matters discussed in the Vinson & Elkins and City Attorney investigation reports, and directing the City Attorney to prepare applicable resolution.

Subitem-C: (R-2005-)

Authorizing an agreement with Willkie, Farr, & Gallagher LLP in the amount of \$500,000 for provision of independent legal counsel to the City Audit Committee and Kroll in connection with the above matters, and directing the City Attorney to prepare applicable resolution.

ADOPTION AGENDA, DISCUSSION, OTHER LEGISLATIVE ITEMS (Continued)

RESOLUTIONS: (Continued)

ITEM-S504: (Continued)

CITY MANAGER SUPPORTING INFORMATION:

In February of 2005, the City of San Diego ("City") entered into an agreement with Kroll, Inc. ("Kroll") to receive, review and evaluate the findings of the investigations performed by Vinson & Elkins ("V&E") and the City Attorney, and to provide consulting assistance in assessing internal control deficiencies affecting matters discussed in the investigation reports (see attached agreement with Kroll). The original agreement was for a not-to-exceed amount of \$250,000.

The scope of Kroll's engagement, as memorialized in the original agreement, is two-phased, the first phase being to serve as an Independent Investigator for matters relating to the unfunded liability of the SDCERS and for errors discovered in the footnotes of the City's audited financial statements. This phase includes working with KPMG to understand their concerns and identify a satisfactory work program to assist them in obtaining the necessary evidence and documentation required by applicable accounting, auditing and professional services. This phase also includes review and evaluation of the investigation reports issues by V&E and the City Attorney.

The second phase includes consultation with City personnel to establish internal controls that, if implemented and properly operated by the City, could provide reasonable assurance that the transactions identified in the reports in Phase One are properly reported and disclosed in the City's financial statements. This work is to be coordinated with the City Auditor and Comptroller, the internal audit department manager, and the City's outside independent auditors as to the scope and nature of internal controls that the City would need to assess, document, implement, and test.

By this action, the agreement with Kroll will be increased by \$1,500,000, for a total not-to-exceed amount of \$1,750,000.

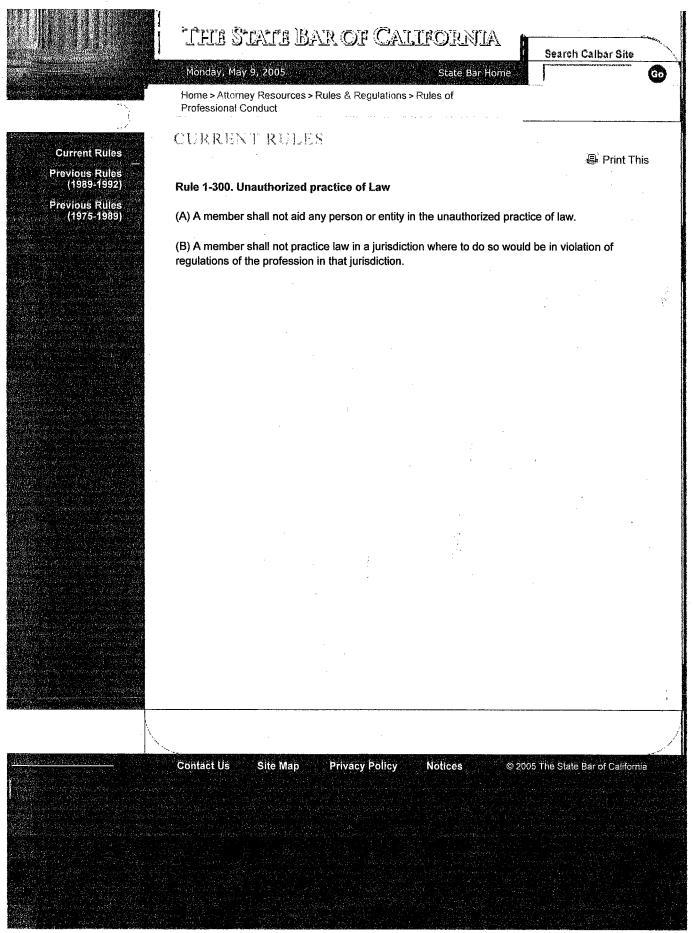
Kroll will also be utilizing independent legal counsel from the firm of Willkie, Farr & Gallagher LLP ("Willkie, Farr"). Willkie, Farr's role will be to provide counsel and assistance to Kroll and the Audit Committee in connection with the independent investigation into SDCERS finances and disclosure, as well as with other matters that, in the judgment of the Audit Committee, may require inquiry or investigation (see attached agreement with Willkie, Farr). Willkie, Farr will report exclusively to the Audit Committee, serving with complete independence from the Mayor and City Council, the City, and the City's departments, agencies and elected officials.

Funding for the retention of Willkie, Farr is being requested in the amount of \$500,000.

Irvine

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December 2004

Eighteen Safeguards To Corporate Self-Investigation

Michael R. Young

WILLIE FARR & GALLACHER LLP

Introduction

Over the past several years, there appears to have been an increasing need for investigations into potential accounting issues at public companies. The need has corresponded, not surprisingly, with an upsurge in reported restatements of financial statements. Where such a restatement is potentially the result of deliberate misconduct, an internal investigation may be necessary both to correct financial misstatements and to demonstrate the sufficiency of the company's remedial action to the SEC, the Department of Justice, or the outside auditor of the company's financial statements.

As some corporate boards have discovered to their woo, the perils in undertaking such an investigation are many. Sometimes they are overseen by a board committee that is later found not to have possessed sufficient independence. Sometimes the law firm engaged by the board's special committee is itself insufficiently independent or not sufficiently sophisticated for the task. Sometimes management interferes with the investigation and the credibility of the investigative conclusions are compromised thereby.

Michael R. Young is a litigation partner in the New York office of Williae Farr & Gallagher LLP specializing in securities and financial reporting. You may reach Mr. Young at (212) 728-8000. A special thanks to PLI All-Star Briefing which first enumerated Mr. Young's Safeguards.



Michael R. Young

Of late, both the SEC and the auditors of financial statements have proved to be particularly tough audiences for special committee investigative reports. Both have demonstrated a strong interest in internal investigations that are independent, thorough, and unlimited in scope. Moreover, both have demonstrated an intolerance for investigative reports that appear to exonerate executives when exoneration does not appear to be completely justified by the facts. With regard to the SBC, the price of an inadequate investigation may include increased regulatory zeal. With regard to the outside auditor, the price may include a failure to obtain an audit report on restated financial statements and, in serious cases, a "10A report" in which the auditor alerts the SEC that the board of directors is not taking "timely and appropriate remedial actions."

While the needs of any investigation will necessarily depend upon the cir-

comstances at issue, experience teaches that certain procedures, established at the outset, can act as a safeguard against undue compromise of an investigation's independence and effectiveness. They are listed below. It may be that, in some investigations, not every safeguard is warranted and that, indeed, not even most of the safeguards would be needed. Still, it is probably useful that they at least be considered:

Righteen Safeguards

- 1. An internal investigation of potential accounting irregularities at a public company should be overseen by an audit committee comprised solely of independent directors or by a similarly comprised special committee of the board hereinefter referred to simply as the "sudit committee").
- 2. The investigation should be undertaken by a substantial law firm of good reputation that has no prior history of reporting to management. Regular outside counsel, or defense counsel in related litigation, will rarely suffice.
- 3. The law firm under normal circumstances must engage an accounting firm to provide forensic assistance.
- 4. The investigation may initially focus on particular issues but is not to be impeded by unreasonable constraint. The investigators are to have license to pursus all evidence of potential improprieties no matter where they may lead. În this regard, SAB 99 may provide useful guidance as to materiality.
- 5. The investigators should consult with the auditor at the outset to ensure that the proposed scope of the investigation will be sufficient to be relied upon

for audit purposes. Throughout the course of the investigation, the auditor should be periodically apprised of the extent to which the scope remains adequate or needs to be expanded.

- 6. The audit committee, as a matter of substance and tone, must express a willingness to, actively oversee the investigation and assume responsibility for its results. It is the audit committee that is to select and engage the law firm responsible for conducting the investigation, and it is the audit committee to whom the investigators are to directly report.
- 7. The sudit committee is to see that all company personnel are encouraged to corperate with the investigation in both substance and spirit. Company personnel are to make themselves available on request; to cooperate to the follest extent possible, to make available all requested documents, and to be truthful and candid with the investigators.
- 8. The audit committee should consider the need to put in place procedures to ensure that executives or employees potentially involved in misconduct are not informed or updated as to investigative progress or tentative results. Executives should not have the opportunity to interfert with the investigation or have any prior substantive contact with individuals being interviewed on the subjects into which inquiry is being made.
- 9. The audit committee, in conjunction with its counsel, should consider the extent in which initial disclosure regarding the investigation and its subject roster may be needed. Draft press releases should be made available for review by the suditor.
- . 10. The investigation may proceed with all available dispatch, but is not to be compromised by inordinate management pressure, upcoming deadlines for the filing of a Form 10-K, or other artificial constraint. The auditor will not permit the scope, quality, or depth of an investigation to be compromised by deadlines.
- The auditor will often seek "complete transparency" between the conduct

of the investigation and the information available to the auditor. In other words, the auditor may not accept, as justification for lack of access to information, assertions of attorney-client privilege or work product. The auditor will ordinarily went to determine, as a matter of its own judgment, those investigative materials it will want to review. The auditor may view a failure to provide those materials as a scope limitation to the audit.

- 12. The audit committee should consult its counsel as to its responsiveness and cooperation with the staff of the SEC in connection with an SEC investigation. That issue should be discussed as well with the auditor insofar as the audit committee may request the auditor to accompany company personnel in SEC presentations.
- 13. On particular issues, investigators may find evidence going both ways both incriminating and exculpatory. The andic committee should understand that the auditor will consider incriminating evidence in assessing appropriate remedial action and its willingness to accept representations from particular individuals.
- 14. Upon the investigation's completion, the investigators should provide a report setting forth, among other things:
- the circumstances giving rise to the investigation;
- the investigation's scope;
- · the persons interviewed;
- sources of documents reviewed;
- · the underlying facts;
- · conclusions as to culpability and
- the numerical explication of any necessary adjustments to the company's financial statements; and
- · proposed remedial action.

The auditor and the audit committee should discuss whether the report should be in writing with appropriate cognizance being taken of the needs and desires of relevant regulators. The audit committee should understand that, regardless of whether a written report is prepared, the auditor will normally doc-

ument important aspects of the report in its workpapers.

- 15. Upon the investigation's completion, the suditor will assess the reasonableness of the scope, findings, and conclusions of the investigation and the extent to which the investigation can be relied upon for the purpose of issuing an sudit report.
- 16. The anditor will separately assess the extent to which the company has taken "timely and appropriate remedial actions" pursuant to section 10A of the 1934 Act. An important aspect of that assessment will often involve the extent to which company personnel have been forthright and candid with investigators and company stakeholders.
- 17. The company will be called upon to provide representations with regard to the investigation and any financial statements affected by its conclusions. The audit committee and investigations should be mindful, throughout the investigation, that the auditor may not be in the position to accept audit-related representations from management as to whom there is evidence of wrongful conduct.
- 18. Throughout the investigation, and upon its completion, the andit committee and its counsel should assess the extent to which additional public disclosure is appropriate. Such disclosure should be reviewed by the auditor prior to its issuance.

Conclusion

The objective of an internal investigation is to help the company put the problem behind it – not to make the problem behind it – not to make the problem
worse. Inadequate investigations can
anger regulators, make difficult or
impossible the procurement of new
andited financial statements, and
increase the apparent guilt of those who
may have done something wrong. A
thorough and independent investigation,
undertaken by sophisticated professionals in a way that safeguards the integrity
of the outcome, serves the interests of a
public company, its board of directors, its
regulators and auditor, and its shareholders.